The "Long Tail" on the Capital Gains Increase – and Its Impact on Business Families

BY STEVE LANDAU

Much has been discussed on the impact of the recent increase to the capital gains inclusion rate, from 50% to 66.6%, effective June 25, 2024. The federal government shared that it designed the increase to extract more tax revenue from ultra-high-net-worth Canadians (who earn much of their annual income by generating capital gains on their investments) to pay for its various spending priorities.

So far, media coverage of this significant change has been focused on the higher tax costs associated with selling investment assets, personal vacation properties, and other near-term property sales that would trigger a taxable capital gain.

There has been little discussion, however, on the "long tail" effect of this increase — namely what is likely to be *the largest tax hit for Canada's leading business families in a generation.*

THE IMPACT OF THE INCREASED CAPITAL GAINS INCLUSION RATE ON ESTATE TAXES

Unlike the U.S., Canada doesn't have an estate tax, per se. Instead, all capital properties (other than a principal residence) are deemed to be disposed of at their fair market value (FMV) on the death of an individual, giving rise to a capital gain based on the difference between that FMV and its original, often nominal, cost for tax purposes. For business owners, this would include the shares they hold in the corporation that carries on the business or of a holding company.

Prior to June 25, the capital gain on death was included at 50%. After that date, the inclusion rate has

increased to 66.6%. The resulting effective tax rate on a capital gains tax liability at death has therefore increased from about 27% to just under 36%, an increase of one-third. The estate tax liability for all Canadians, including our leading business family owners, *just became 33% more expensive due to the inclusion rate increase.*

TAX PLANNING AND FUNDING — MORE IMPORTANT THAN EVER

There are, in fact, many effective tax planning strategies available to help manage the estate tax liability. The real challenge for most families is to select the strategy – or combination of strategies - that works best for their particular situation. Some examples would be tax on property left to a surviving spouse or a spousal trust deferred until the second death. Another would be corporate reorganizations/estate freezes. Many successful business families have completed one or more estate freeze transactions which have allowed them to spread the tax liability amongst different generations of the family.

However, in the final analysis, while planning strategies like the above can help manage when the tax is due, the increased inclusion rate still means that *ultimate future liability will be 33% more expensive.* And at 33% more expensive, many families are wondering where the money will come from.

An ever-increasing concern for business families, especially after the capital gains tax increase, is how each generation's estate tax liability will be funded. Many funding strategies can be deployed, including borrowing against business assets, sale of property, sinking fund or investment fund, and life insurance. Most often, it will be necessary to include a combination of these different approaches. Some of these strategies are more cost-effective (or tax-effective) than others.

THE IMPACT ON LIFE INSURANCE UNDER THE NEW RULES

A foundational strategy for many business-owning families – one that will avoid a potential liquidity crisis for the family upon death – is the use of a custom-designed life insurance portfolio. Many experts hold the view that with estate tax liabilities increasing, life insurance can play an even more financially and tax-efficient role in developing a customized approach to the family's plan for funding this obligation. This is especially true since life insurance hasn't been affected by the increased capital gains inclusion rate.

In fact, one of our initial observations from our detailed modelling of the change to the capital gains inclusion rate is how life insurance can play

an even *more* effective role in reducing the impact of this increased liability. Dividend tax rates haven't increased in the budget; only capital gains rates have. There is much opportunity to recharacterize these gains through post-mortem tax strategies which utilize the life insurance proceeds to redeem the shares that gave rise to the estate tax liability.

It's also worth remembering that life insurance *helps families pay their tax, not avoid it*. We all know that Canada's leading business families carry a significant portion of the country's tax load and are major contributors to our nation's prosperity. Proper tax planning, including the use of life insurance, helps families pay their estate tax without disrupting the ongoing success of their businesses.

Navigating the ever-changing tax landscape and the capital gains inclusion rate can seem daunting, but with the knowledge and a well-thought-out strategy, you can turn it to your advantage. Through sophisticated financial modelling and understanding how this rate affects your investments and holdings, you'll be much better equipped to design and implement tax planning to work *for* you.

Steve retired as a partner of Ernst & Young in June 2021 following a 30-year career with the firm. Prior to his retirement, Steve's practice focused on advising entrepreneurs with the design and implementation of tax strategies for the sale or recapitalization of privately owned businesses, including advising on estate planning matters related to the monetization of family wealth.

With CMG, Steve focuses on helping clients and their professional advisors understand the tax and estate planning implications of their life insurance planning.