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TAXSTRATEGY

Minimize double taxation and maximize cash flow to your estate with…

Proper planning

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Are you an investor who owns shares of a private holding company or investment corporation? Are you nearing retirement, or already retired?

Proper financial planning helped get you where you are now, and is essential to your continued success.

In the absence of good planning a big chunk of the fair market value proceeds of your estate will be eaten up through double taxation – first on the corporate level, and then on the personal level.

This article will help those Canadians who want to avoid that double – or potentially triple – taxation.

Competent "post-mortem" planning by professionals can help reduce the impact of double taxation by using corporate-owned life insurance, enabling your estate to keep more of what you have worked so hard for all these years.

When a shareholder of a Canadian-controlled private corporation thinks about estate planning, the first thing that comes to mind is usually an estate freeze. But post-mortem planning is more than that.

The primary goal of post-mortem planning is to minimize the tax burden at death. When an individual owns shares in a private corporation, post-mortem planning can reduce or eliminate the double taxation that can result from a) the deemed disposition of the shares at death and b) the tax liability on the final distribution of the assets out of the corporation.

Some people actually consider the term "double taxation" to be somewhat of a misnomer, since tax can arise out of three possible situations: paying capital gains at death, a tax on disposition of investments in the corporation and tax in the hands of the individual or estate on any dividends received from the corporation.

But since there are still two levels of taxation, we will keep the "double taxation" moniker.

The potential for double taxation arises when a taxpayer dies owning shares of a private corporation (which can include a holding company or operating company) that, in turn, holds real estate, marketable securities, other investment assets and shares of business corporations.

The best way to explain the situation is through an example.

Mrs. Jones, recently deceased, owned all the shares of a private corporation that had a fair market value of $1 million.

The business itself owns a piece of land that has a present fair market value of $1 million, but the company originally paid only $100,000 when it bought the land some 25 years ago.

Under the Canada Income Tax Act, Mrs. Jones was considered to have a deemed disposition of the shares of her company upon her death.

While she was the business owner she didn't pay anything for her shares, giving her a capital gain of $1 million on her final tax return, for which she was assessed $230,000 (the first

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part of the double taxation).

Mrs. Jones leaves the shares to her two children in her will. Under the Act, the two children are deemed to have acquired their mother's shares for proceeds equal to the fair market value of the shares at the time of their mother's death – or $1 million.

Right now, if they sell their shares in the company for the same amount, there is no capital gain because that's the fair market value of the shares. Instead, the two children decide to sell the land owned by the business.

Remember: the land was originally purchased for $100,000. The company now realizes a capital gain of $900,000 and the corporation pays a tax of about $211,500 (the second part of the double taxation).

Under this scenario, Mrs. Jones and her two children (directly and through the corporation) paid a total of $441,500 (or 44 per cent) in tax on a capital gain of $1 million.

Had there only been one level of taxation, they would have paid only about $230,000, or 23 per cent. (There can also be a third level of tax as the executor winds up the company to access the cash value of any investments.)

If Mrs. Jones had received the proper tax-planning advice, however, she could have taken a different approach that would have covered the estimated future tax liability.

For example, she might have purchased a corporate life insurance policy with a face amount that would have basically eliminated that tax debt.

Life insurance provides an effective way to fund tax liability and redemption strategies (especially when fixed-value preference shares are involved) – and it can also be used for estate preservation.

A number of options are available for taxpayers looking to do just that.

A husband and wife can buy a joint last-to-die term to 100 life insurance policy with a face amount that would cover the estimated future tax liability which would arise upon their deaths.

The premiums could be funded by liquidating a portion of any interest-bearing investments every year. In the end, the life insurance proceeds are received tax-free by the company. This, in turn, gives the company other tax advantages.

Varying strategies can be used depending on whether the ownership of the holding or operating company is in common shares or fixed-value preference shares. Another consideration is "where."

In some provinces, capital gains treatment leads to a lower tax burden than dividend treatment, so a strategy that takes this into account may be preferred over others. This situation can change if there are modifications to dividend or capital gains tax rates.

Professionals can also use a spousal rollover and share redemption method so there is no tax payable on the death of the taxpayer.

Other strategies

Depending on the circumstances, capital loss planning strategies can be combined with more sophisticated post-mortem tax planning.

One of them is called "pipeline" planning," aimed at eliminating double taxation stemming from the deemed disposition of shares on death and the tax payable by beneficiaries on dividend income.

Another such approach is called "bump" planning, again with the end result of distributing shares to beneficiaries with little to no additional tax cost.

Some of these strategies can be complex and should be reviewed carefully to determine which provides the best overall tax results.

Your will and other estate planning agreements should be flexible enough to allow whatever structure is used to reduce the tax burden under the rules that exist at the time of death. Since rules can change over time, it's a good idea to not only have a rule in place, but to have it reviewed periodically.

Life insurance is an ideal solution to provide for your beneficiaries following your death, regardless of your financial circumstances.

For taxpayers with a Canadian-controlled private corporation, life insurance can also help minimize double taxation and help maximize cash flow to the estate.

As you can see, using methods to lower or eliminate double taxation can be complicated and require planning. The CRA will happily take your tax dollars, but wouldn't you prefer to leave your estate to someone of your choosing? ❐