Post-Mortem Planning for Private Corporation Shares

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The Issue

Double Taxation on Deemed Disposition of Private Corporation Shares

- "If You Fail to Plan, You Are Planning to Fail" — Benjamin Franklin

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The Issue

Deemed Disposition at Death of Capital Property at Fair Market Value

- Individual taxpayer is deemed to have, immediately before the taxpayer’s death, disposed of each capital property of the taxpayer and received proceeds of disposition equal to the fair market value (“FMV”) of the capital property immediately before the taxpayer’s death
- Individual’s estate will pay tax (26.76% at the highest marginal tax rate in Ontario) on any resulting capital gain
- Estate’s adjusted cost base (“ACB”) of the property deemed to be FMV of the property

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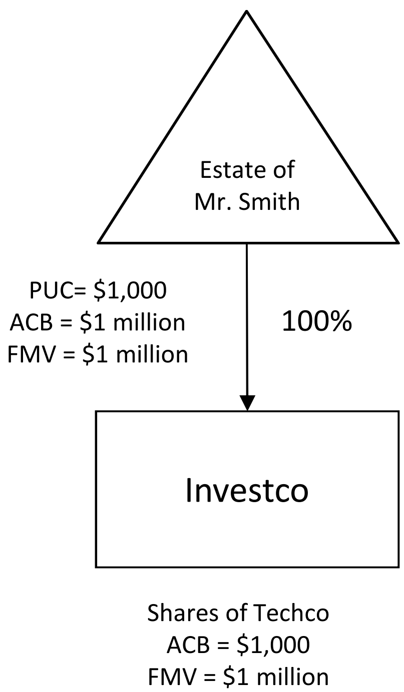
The Issue

Double Taxation on Deemed Disposition of Private Corporation Shares



- Mr. Smith subscribes for shares of Investco for $1,000 in 2000
- Investco uses subscription proceeds to purchase shares of Techco for $1,000
- Shares of Techco have a FMV of $1 million on Mr. Smith's death
- Where Investco has no assets or liabilities other than its shares of Techco, Mr. Smith's shares of Investco also have a FMV equal to $1 million
- Mr. Smith's estate will pay $267,332 in tax (at highest marginal rate in Ontario) on $999,000 capital gain resulting from deemed disposition of Mr. Smith's shares of Investco on Mr. Smith's death
- Investco will later pay tax on capital gain realized on sale of shares of Techco (second layer of tax on same economic gain)
- Mr. Smith's estate, or his beneficiaries, will pay tax on the taxable portion of the distribution by Investco of the after-tax proceeds of the sale of the Techco shares (third layer of tax on same economic gain)

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Methods for Reducing Double Taxation

3 Methods

- Subsection 164(6) loss carryback

  – substitutes dividend to the estate in its first year for capital gain in deceased's final year

- Post-mortem pipeline

  – facilitates estate or beneficiaries withdrawing funds tax-free from Investco (reducing third layer of tax)

- Paragraph 88(1)(d) Bump

  – results in an increase of ACB of non-depreciable property (e.g. Techco shares) owned by Investco (reducing second layer of tax)

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Subsection 164(6) Loss Carryback

Result:

- Replaces Mr. Smith's final year capital gain with a deemed dividend to Mr. Smith's estate

Mechanics:

- Investco redeems estate's shares (or Investco is wound-up) resulting in a deemed dividend to estate
- Estate realizes a loss generally equal to the amount of the deemed dividend
- Estate files subsection 164(6) election to carry back loss to deceased's final year to be applied against capital gain realized on deemed disposition of deceased's shares of Investco

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Subsection 164(6) Loss Carryback

Mechanics:

- Must be completed within 12 months of Mr. Smith's death
- Estate must be a graduated rate estate ("GRE")
- By implementing a subsection 164(6) loss carryback, estate is substituting a deemed dividend taxed in estate's first year at 39.34% (eligible dividend – where Investco has a general rate income pool ("GRIP") balance) or 47.74% (other than eligible dividend) for a capital gain taxed in Mr. Smith's final year at 26.76%

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Subsection 164(6) Loss Carryback

Tax Rates on Deemed Dividends vs. Capital Gains

Tax Efficiency - Lower Effective Tax Rate on Deemed Dividend With CDA and RDTOH

- Effective tax rate on deemed dividend can be reduced if Investco has (or can generate) a capital dividend account ("CDA") balance, and Investco elects to treat a portion of the deemed dividend as a tax-free capital dividend
- To the extent that Investco has (or can generate) refundable dividend tax on hand ("RDTOH"), Investco will receive a refund on RDTOH on portion of deemed divided to estate which is taxable dividend

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Subsection 164(6) Loss Carryback

Tax Rates on Deemed Dividends vs. Capital Gains

Stop Loss Rules

- Subsection 40(3.6) – subsection 40(3.61) exception where share of corporation held by a GRE is redeemed and GRE elects under subsection 164(6) to carry back the loss to deceased's final year

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Subsection 164(6) Loss Carryback

Tax Rates on Deemed Dividends vs. Capital Gains

Stop Loss Rules

- Subsection 112(3.2) – loss on redemption of GRE's shares of Investco which can be carried back under subsection 164(6) to Mr. Smith's final year is reduced to the extent that portion of deemed dividend which is a capital dividend exceeds one-half of the lesser of the loss otherwise determined and the capital gain to Mr. Smith on the deemed disposition of his shares of Investco
- Implement "50% rule" to avoid loss grind

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Post-Mortem Pipeline

Result:

- Estate can receive tax-free distribution from Investco equal to high ACB of Investco shares

Mechanics:

- Estate transfers its high ACB shares of Investco to a Newco owned by estate and receives a promissory note in the amount of the ACB as consideration
- Investco later satisfies promissory note with cash – tax-free to estate

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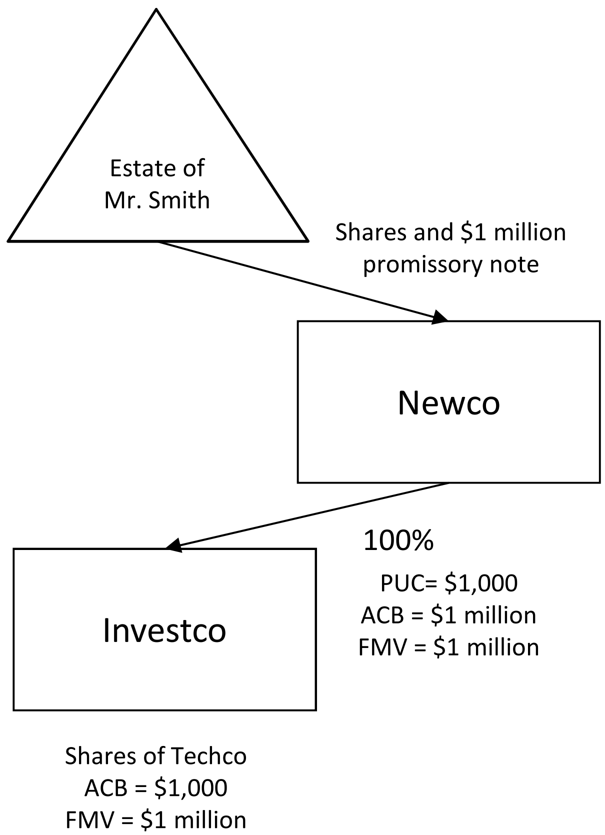
Post-Mortem Pipeline



- Preserves $999,000 capital gain in Mr. Smith's final year
- Can be combined with paragraph 88(1)(d) bump of ACB of Investco's shares of Techco on subsequent amalgamation of Newco and Investco or wind-up of Investco into Newco

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Post-Mortem Pipeline

- Before implementing a post-mortem pipeline, consider the anti-surplus stripping rule in section 84.1 and the deemed dividend rule in subsection 84(2)
- The CRA has ruled that it may apply anti-surplus stripping rule in section 84.1 and the deemed dividend rule in subsection 84(2) to a post-mortem pipeline unless:
  a) Investco carries on a business or investing activities at the time of the transfer by the estate to Newco of shares of Investco, and continues to carry on the business or investing activities for a period of at least one year following the transfer;

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Post-Mortem Pipeline

b) Investco is not amalgamated or wound–up into Newco for at least one year following the transfer;

c) the amount of the promissory note issued by Newco to the estate as consideration for the transfer to Newco of the estate's shares of Investco does not exceed the “arm’s length” ACB of the estate’s shares of Investco, and is repaid in a series of instalments following the first anniversary of the transfer of the shares;

d) the repayment may be funded by the sale of Investco’s (or the amalgamated corporation’s) assets, and so long as it otherwise continues to carry on its business; and

e) dividends paid out of current earnings and funded without the sale of assets are permitted

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Paragraph 88(1)(d) Bump

Result

- Increase cost base of non-depreciable capital property, e.g. Investco's shares of Techco, but not depreciable property, such as buildings

Mechanics

- Estate transfers high ACB shares of Investco to Newco
- Investco is amalgamated with or wound-up into Newco
- Newco designates in return non-depreciable capital property whose cost is to be increased

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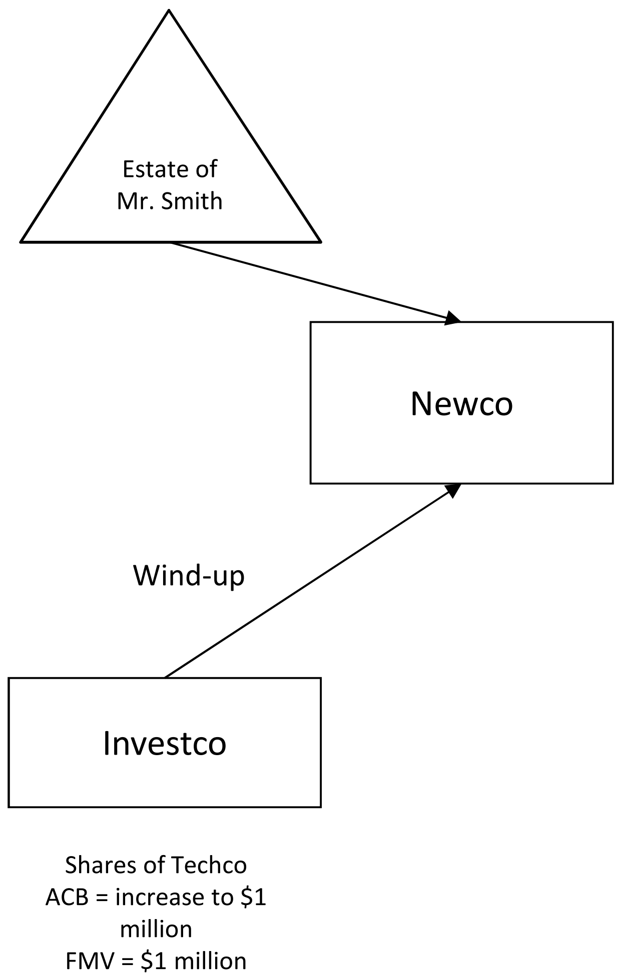
Paragraph 88(1)(d) Bump



- Preserves capital gain in Mr. Smith's final year
- Can be combined with post-mortem pipeline

Paragraph 88(1)(d) Bump

Requirements

- Non-depreciable property, e.g. Techco shares, must be owned continuously since Mr. Smith's death
- Increase in ACB of Techco shares limited to "available bump room", being the amount by which FMV of Techco shares at Mr. Smith's death exceeds greater of ACB of shares at Mr. Smith's death and at time Investco is wound-up and reduced by:

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Paragraph 88(1)(d) Bump

Requirements

a) cost of Investco's other assets, including cash, in excess of Investco's debts and reserves; and

b) the total of all taxable dividends, capital dividends, and life insurance capital dividends received by Newco from Investco

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Choosing Between the Methods

Subsection 164(6) Loss Carryback

- Substitutes dividend in estate's first year for capital gain in Mr. Smith's final year
- At highest marginal tax rate in Ontario, capital gains taxed at 26.76%, while eligible dividends are taxed at 39.34%, and non-eligible dividends taxed at 47.74%
- Estate would choose subsection 164(6) loss carryback option where it has CDA or RDTOH, or GRIP, beneficiaries wish to wind-up Investco within short time after Mr. Smith's death, or where CRA administrative requirements for post-mortem pipeline cannot be met
- Investco can generate CDA and RDTOH by selling capital property to affiliated corporation
- Only available if Mr. Smith's estate is a GRE, must be competed within one year of Mr. Smith's death

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Choosing Between the Methods

Post-Mortem Pipeline

- Preserves Mr. Smith's capital gain (taxed at 26.76%), and permits estate to receive tax-free distribution from Investco
- No time limit on implementation
- Implementation costs and delay in distribution from Investco - requires incorporation of Newco, transfer of Investco shares to Newco, and Investco must continue to carry on its business or investment activities, and Investco cannot distribute proceeds of sale of its assets, for at least one year
- Can be combined with paragraph 88(1)(d) bump

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Choosing Between the Methods

Paragraph 88(1)(d) Bump

- Preserves Mr. Smith’s capital gain (taxed at 26.76%)
- Only available for non-depreciable capital property
- Non-depreciable capital property must be owned Investco continuously since Mr. Smith’s death
- No time limit on implementation
- Can be combined with post-mortem pipeline
- Consider complicated “bump denial rules”

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Conclusion

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Thank you for your time!

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Questions?

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