

Tax + Estate Business Owners Kit

Part 5 Minimizing double taxation after death



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Part of a healthy estate plan for an incorporated business owner involves pre-planning for taxation after death.

This is often referred to as post-mortem tax planning. Without tax planning, your client's graduated rate estate (GRE) may encounter a double and sometimes a triple tax burden.

At death, taxes can be triggered at three levels:

- 1 Personal or terminal**
- 2 Corporate**
- 3 Estate**

This is Part 5 of the Tax and estate planning for incorporated business owners series



**With proper planning,
double taxation can be
reduced or eliminated.**

Post-mortem tax planning

Terminal tax is triggered when the deemed disposition of shares is reported at fair market value (FMV) on the business owner's final tax return (the first level of tax).

Corporate tax is triggered when the underlying corporate assets are disposed (the second level).

Finally, **dividend rates** apply to the value extracted when the company is wound up or shares redeemed by the executor of the deceased's GRE (the third level).

The deceased GRE has now been exposed to double taxation because the fair market value has been taxed twice, once at capital gains rates (the deemed disposition of the shares at death) and again at the higher dividend rates on wind up or redemption.

The good news is that, with proper planning, double taxation can be reduced or eliminated. For instance, the capital gain reported at death can be offset by the capital loss under what is known as a "164(6) loss carry back" strategy. This would eliminate the capital gains tax and instead expose the GRE to dividend tax rates. On the other hand, an alternative strategy known as the "post-mortem pipeline" can alleviate the dividend tax when the corporate proceeds are distributed on wind up or redemption, accessing the lower capital gain rates.

Part 5 of the incorporated business owner's series illustrates how double taxation arises, and how the 164(6) and pipeline strategies can alleviate a layer of tax to tackle the issue. This is best illustrated by way of an example.

Example:

Rocco (Toronto resident), and an incorporated business owner, held all the outstanding nominal shares on death. Rocco's company manages an active investment portfolio, holding investments worth \$10M with no accrued gains. Rocco's adjusted cost base (ACB) and paid-up capital (PUC) are both \$1. The ACB refers to what he paid for the shares, and PUC is derived from transactions with the company. Assume top rates and no corporate balances.

Terminal tax

A deceased individual is deemed to have disposed of all capital property at FMV immediately before death. Thus, for terminal tax, Rocco's deemed disposition of shares amounts to the difference between the FMV of \$10M and ACB of \$1, 50% of which is a taxable capital gain. As shown in Table 1, Rocco's personal tax owing at death is almost \$2.7M.

Corporate tax

Usually, corporate tax would be payable if the company held an investment portfolio with accrued gains. Half of the capital gain is subject to corporate taxes, and the non-taxable portion can be paid tax-free to the GRE by way of the capital dividend account (CDA). Corporate tax can be reduced through the corporation's refundable dividend tax on hand (RDTOH) account when a required dividend is paid. This requirement can be met when the executor winds up the corporation or the company's shares are redeemed. In this case, there are no accrued corporate gains, and therefore corporate tax is nil. (Please refer to Part 2 for more information on CDA and RDTOH)

Estate tax

The deceased's GRE is deemed to have acquired the shares at FMV immediately after death. In order to distribute proceeds to GRE beneficiaries, the executor can either wind up the company or authorize a share redemption deeming the GRE to receive a dividend equal to the company's value in excess of PUC (see Table 1). In addition to the deemed dividend, the GRE is also deemed to dispose of their shares of the company. The proceeds of disposition can be reduced by the deemed dividend, creating a capital loss. The capital loss can be carried back to the terminal return to offset the capital gain tax reported at death, provided the windup or redemption is administered in the GRE's first taxation year (164(6) strategy). For those who don't plan, the capital loss may be wasted and will only be available for future taxation years.

Without any tax planning, a 75% tax rate could apply (**see Table 1**). Rocco's company has been taxed twice: once at capital gain rates arising from the deemed disposition of the shares reported on the terminal return, and again at the higher non-eligible dividend rate when the company is wound up or shares redeemed.

Table 1 – Double taxation with no tax planning

	Tax rates	Corporate tax Share value	Terminal tax Capital gain	Estate taxes Wind up	Estate share disposition	Tax summary
Proceeds		10,000,000	10,000,000	10,000,000	10,000,000	
ACB		10,000,000	-	-		
Capital gain		-	10,000,000	-		
Taxable capital gain (50%)		-	5,000,000	-		
Deemed dividend				10,000,000	(10,000,000)	
Adjusted proceeds					-	
Adjusted cost base (inherited by estate)					10,000,000	
Capital loss available to carryback					(10,000,000)	
Personal tax	53.53%	-	2,676,500	-		
Refundable tax	30.67%	-	-	-		
Taxable dividend	47.74%	-	-	4,774,000		
Total tax		-	(2,676,500)	(4,774,000)		(7,450,500)
						(74.51%)
Share value		10,000,000				

Note: The ACB/PUC not included in corporation due to immaterial nature.



Table 2 – 164(6) Loss carryback strategy

	Tax rates	Corporate tax Share value	Terminal tax Capital gain	Estate taxes Wind up	Estate share disposition	Tax summary
Proceeds		10,000,000	10,000,000	10,000,000	10,000,000	
ACB		10,000,000	–	–		
Capital gain		–	10,000,000	–		
Capital loss carryback 164(6)			(10,000,000)			
Taxable capital gain (50%)/(CDA)		–	–	–		
Deemed dividend				10,000,000	(10,000,000)	
Adjusted proceeds					–	
Adjusted cost base (inherited by estate)					10,000,000	
Capital loss available to carryback					(10,000,000)	
Personal tax	53.53%	–	–			
Refundable tax	30.67%	–	–			
Taxable dividend	47.74%	–	–	4,774,000		
Total tax		–	–	(4,774,000)		(4,774,000)
						(47.74%)
Share value		10,000,000				

Note: The ACB/PUC not included in corporation due to immaterial nature

Table 3 – Pipeline strategy

	Tax rates	Corporate tax Share value	Terminal tax Capital gain	Estate taxes Wind up	Estate share disposition	Tax summary
Proceeds		10,000,000	10,000,000	–		
ACB		10,000,000	–	–		
Capital gain		–	10,000,000	–		
Taxable capital gain (50%)		–	5,000,000	–		
Deemed dividend				–	–	
Adjusted proceeds					–	
Adjusted cost base (inherited by estate)						
Personal tax	53.53%	–	2,676,500	–		
Refundable tax	30.67%	–	–	–		
Taxable dividend	47.74%	–	–	–		
Total tax		–	(2,676,500)	–		(2,676,500)
Share value		10,000,000				(26.77%)

164(6) Loss carry back strategy

The significant capital loss available for carry back arises on the difference between the adjusted proceeds and the GRE's acquired high cost base, which can then be carried back to offset the capital gain reported on death by way of the 164(6) election. Provided the loss is triggered in the GRE's first taxation year, the 164(6) strategy allows the capital loss to offset the capital gain reported at death, eliminating double taxation. This can be accomplished by filing a T1 amendment, or a request to apply the loss can be filed with the original T1 return.

Although not applicable in Rocco's case, the strategy's effectiveness relies on the presumption that corporate assets with accrued gains are sold first before the company is wound up or shares redeemed. This ensures corporate tax balances such as CDA and RDTOH are available, which can help reduce the dividend tax impact. Please note, the allowable capital loss available for carry back may be restricted when an excessive CDA amount is paid.

GRE status is required for available use of this strategy. For an estate to be classified as the deceased's GRE, it must be a testamentary trust, the executor must elect in the trust's first taxation year that it's a GRE, and no other estate for the deceased can be designated as such. If the intent is to utilize this strategy, it's crucial that GRE status be maintained, since tainting can accidentally occur if, for example, certain loans are made to the estate.

The GRE is one of the only trusts that can access graduated tax rates for up to 36 months subsequent to death (after which, like most trusts, top personal income tax rates apply). The GRE is also the only trust authorized to have an off-calendar year-end during the same 36-month period, so access to graduated tax rates during this time is possible with a date of death year-end.

The 164(6) is a cost-effective option which eliminates terminal tax reducing the combined tax rate to 47.74% (see **Table 2**). Although this option manages to reduce tax if no planning was considered, it does not ponder that the capital gains tax rate is lower than the non-eligible dividend rate (discussed in the pipeline strategy) so the GRE pays tax at the higher dividend tax rate on the fair market value as opposed to the lower capital gain rate. This strategy is best utilized if timely GRE administration is possible as the loss cannot be carried back if realized after the GRE's first taxation year.

Post-mortem pipeline strategy

The pipeline strategy allows the estate to extract corporate funds without incurring the additional higher rate dividend tax.

Immediately after Rocco's death, the company shares are deemed acquired by Rocco's estate for \$10M, otherwise known as "hard ACB". The hard ACB can be converted to cash or debt via a post-mortem pipeline. This can eventually be withdrawn from the company tax-free, eliminating the dividend tax.

In order to accomplish this, Rocco's estate incorporates a new company (i.e., Newco). Rocco's executor transfers the company shares to Newco. In exchange for the shares, Rocco's estate takes back a promissory note equal to \$10M. As the shares are transferred to Newco soon after Rocco's death, the fair market value of the company shares (i.e. \$10M) is the same as the adjusted cost base of the company shares for the estate (i.e. \$10M) so there is no additional capital gain realized by the estate on the transfer.

Now, Newco owns the company shares worth \$10M and owes \$10M to Rocco's estate. The investments in Rocco's original company are then sold for \$10M and the cash is distributed to Newco which then uses the cash to pay off the promissory note to Rocco's estate. This strategy eliminates the dividend tax that would otherwise be payable if no planning was in place.



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The pipeline manages to access the lower capital gain rates and eliminates the higher dividend tax, reducing the effective tax rate to 27%. Although not relevant in this scenario, it's worth noting that if the underlying corporate assets include land or marketable securities, it's possible to bump up the ACB to its FMV, reducing or eliminating corporate tax by way of the 88(1)(d) election when the original corporation is amalgamated with Newco. To accomplish this, certain conditions must be met such as the original corporation should be continued separately for at least one year before the amalgamation.

Conclusion

Undergoing a post-mortem pipeline is usually a complicated, timely and costly process. However, the tax savings may more than offset those costs by not only eliminating a layer of tax but accessing favourable capital gain rates. This strategy requires meticulous planning that must be followed otherwise the plan could be challenged by CRA.

You should speak with your professional advisors, so they may help with tax-efficient options that address your family dynamic and ensure that your will properly reflects those wishes.

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General Inquiries

For all of your general inquiries and account information please call:

English: 1-800-387-0614

Bilingual: 1-800-387-0615

Asian Investor Services: 1-888-465-1668

Fax: 1-866-766-6623

E-mail: service@mackenzieinvestments.com

Web: mackenzieinvestments.com

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