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Post-mortem planning in action: the 50% and 100% solutions

How do business owners help to ensure they don't end up paying capital gains taxes on their shares at death and dividend taxes when their corporation distributes assets to their estate or heirs? They do it by including loss-carryback planning into their post-mortem estate plan. With life insurance, loss-carryback planning may result in less tax payable (compared to where life insurance isn't used).

This article looks at the following interrelated subjects:

- Loss-carryback planning
- The stop-loss rules
- The 50% and 100% solutions

Distributing assets from a corporation after death may lead to a significant tax bill without any post-mortem planning.

Example: Ben owns all the shares of an investment company (Holdco), which have a nominal adjusted cost base (ACB) and paid-up capital. Holdco owns $1,000 of cash. When Ben dies, he's deemed to dispose of his shares at fair market value (FMV) for tax purposes (assuming there's no spousal rollover). Assuming Ben's marginal tax rate is 50%, this disposition creates a taxable capital gain of $500 which produces a tax liability of $250. Ben's will instructs the executor to wind up Holdco so his children can access the $1,000. This results in a $1,000 deemed dividend which is taxable to Ben's estate (which is designated as a graduated rate estate, a "GRE"). In turn, this creates a dividend tax liability of approximately $450, assuming the estate has a 45% marginal tax rate on non-eligible dividends. Ben's terminal return and estate are now facing combined tax bills of $700.

Double taxation at death and loss-carryback planning

Here's how the loss-carryback planning works with and without life insurance:

- **Without life insurance**: would eliminate the $250 capital gains tax liability and leave the $450 dividend tax liability intact.
- **With life insurance**: the $250 capital gains tax liability is eliminated (or reduced) and cuts the dividend tax liability by half (or less). This is discussed below in more detail.

Loss-carryback planning requires a share redemption

A "loss carryback" means that there's a current year loss to carry back somewhere. The loss is a capital loss realized by the estate and it's carried back to offset the capital gain realized by the deceased. Here's how this happens.

At death, a shareholder is deemed to dispose of their shares at the fair market value immediately before death for tax purposes (assuming there's no spousal rollover). This may create a capital gain on the deceased shareholder's terminal return. The deceased's estate now owns the shares and the new ACB of the shares is equal to that FMV. The corporation redeems (e.g., buys back) the shares from the estate and cancels them. The redemption proceeds in excess of the paid-up capital of the shares are deemed to be a dividend for tax purposes. In most cases, the share redemption also creates a capital loss in the estate.
How does this work? The share redemption creates proceeds of disposition that get reduced by the deemed dividend. Because the redeemed shares had a high ACB (that's equal to the FMV immediately before death), this stepped-up ACB is greater than the reduced proceeds of disposition. This results in a capital loss realized by the estate. If the share redemption occurs within the first tax year of the estate (the estate must be a GRE), the estate may elect to carry back this capital loss to offset capital gains in the deceased's terminal return. This is pursuant to subsection 164(6) of the Income Tax Act (Canada).

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Using life insurance to fund the share redemptions

Insured share redemptions occur when the corporation uses insurance proceeds to fund the redemption of shares. The corporation then elects for some or all of the deemed dividend(s) to be a tax-free capital dividend[i]. Specifically, the corporation is the beneficiary of a policy and receives the death benefit as a consequence of the insured shareholder's death. The corporation therefore obtains a capital dividend account (CDA) credit that's generally equal to the death benefit less the policy's adjusted cost basis. To the extent the corporation has a CDA balance, it may pay tax-free capital dividends to its Canadian resident shareholders. For a share redemption, the death benefit gets used to pay the purchase price for the redeemed shares. The resulting CDA credit allows the corporation to elect that all or part of the deemed dividend(s) arising on the redemption is a tax-free capital dividend.

The stop-loss rules and the 50% solution

Without a stop-loss rule, using life insurance in loss-carryback transactions can result in no tax for either the deceased or the estate. The taxable capital gain realized by the deceased gets eliminated by the loss carryback and the deemed dividend to the estate may be tax-free using the CDA. The Department of Finance thought this result was too good of a deal and introduced the stop-loss rules in April 1995. Some existing arrangements were then grandfathered.

The stop-loss rules can seem complicated. Basically, they say if more than half of the deemed dividend to the estate is a tax-free capital dividend, then the estate can't carry back all or part of its loss. Generally, if only half of the deemed dividend is a tax-free capital dividend, the estate may carry back the full loss.

This is the "50% solution" – only electing half of the deemed dividend to the estate as a capital dividend, allowing the estate to carry back the full loss to offset the gain realized in the deceased's terminal return. The remaining CDA, can get used by the corporation to distribute other non-insurance assets to Canadian resident shareholders via tax-free capital dividends.

If the entire deemed dividend is a tax-free capital dividend, the estate gets restricted from carrying back half the capital loss from the share redemption. This is the "100% solution". It's generally regarded as a waste of CDA (unless a corporation has no other assets to distribute).

Example – Full redemption

Meet Betty. Here's her background:

- 60 years old
- Owns fixed-value shares of the family operating company (Opco), which have a total redemption value of $1 million

Betty's advisor recommends that Opco purchases $1 million of coverage to fund a post-mortem share redemption. Opco purchases a Canada Life™ universal life policy on Betty's life with $1 million of coverage (level death benefit).

Let's assume Betty dies at age 90. Both the policy's death benefit and corresponding CDA credit to Opco is $1 million.

The following table shows tax consequences of using the "100% solution," "50% solution" and a loss carry-back with no CDA to Betty's terminal return and her estate. Assume her marginal tax rate is 51% and her estate's marginal tax rate on non-eligible dividends is 44%.

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	No life insurance	100% solution	50% solution
	No CDA $	Redemption using full CDA $	Redemption using half CDA $
Capital gain on final return (after loss carry-back)	0	500,000	0
Taxable dividend in estate	1,000,000	0	500,000
Capital dividend in estate	0	1,000,000	500,000
Capital loss in estate on redemption	(1,000,000)	(1,000,000)	(1,000,000)
Capital loss carried back to final return	(1,000,000)	(500,000)	(1,000,000)
Tax on capital gain on final return	0	**127,500**	0
Tax on taxable dividend in estate return	**440,000**	0	**220,000**
CDA leftover	N/A	0	500,000
Value of CDA leftover			**220,000**

The “100% solution” results in less tax today, but the “50% solution” results in less tax overall when the value of the leftover CDA gets factored into the equation. Which one would your client use?

Example: Redemption where only the tax liability gets insured

As an alternative to this scenario, instead of insuring the full redemption of $1 million worth of shares, Opco purchases enough coverage to pay Betty’s anticipated total tax liability arising at death. Betty’s savvy advisor understands that if she did an insured share redemption using this lower amount of coverage, her anticipated total tax liability arising at death will actually be less than an anticipated capital gains tax liability of $255,000.

So, how much coverage and CDA does Betty actually need? The formula is:

Betty’s anticipated capital gains tax liability divided by 1 plus (tax rate on regular income – minus the tax rate on non-eligible dividends).

Example: the amount is $238,318 ($255,000/1+(0.51-0.44)). The result is a post-mortem transaction where $476,636 worth of Betty’s shares get redeemed and the remaining shares get gifted to her heirs.

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	Insure tax liability only and use the 50% solution $
Shares redeemed (FMV)	476,636
Taxable dividend in estate	238,318
Capital dividend in estate	238,318
Capital loss in estate on redemption	476,636
Capital gain on terminal return (after loss carry-back)	523,364
Tax on taxable dividend to estate	104,860
Tax on capital gain to deceased	133,458
Total taxes	238,318

Conclusion

In summary, business owners and their tax advisors need to consider their post-mortem planning options, or they and their family members may unnecessarily pay too much tax. Loss-carryback planning is a type of post-mortem transaction for business owners. Whether the “50% solution” or “100% solution” gets used and whether the full value of the shares (or only a part) gets redeemed, loss-carryback planning may work better when used with life insurance.

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This information is provided by The Canada Life Assurance Company and is current as of April 2021.

[i] More specifically, if only a portion of the dividend is to be a capital dividend then the corporation will undertake a transaction that results in two dividends paid so that one dividend is in its entirety elected to be a capital dividend.

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