Post-mortem planning for business owners

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How do business owners ensure that they don't end up paying capital gains tax on their shares at death *and* dividend tax when their corporation distributes assets to their estate or heirs? They do it by implementing a post-mortem planning strategy. Either loss carryback planning, pipeline planning, or a combination of both.

Distributing assets from a corporation after death may lead to a significant tax bill without any post-mortem planning. For example, let's consider Ben's situation.

Ben owns all the shares of an investment company (Holdco), which have a nominal adjusted cost base (ACB) and paid-up capital (PUC). Holdco has $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. 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, an effective tax rate of 70%! This is an example of the potential tax consequences of doing no post-mortem planning.

Generally, post-mortem planning is designed so that the business owner and their estate pay either capital gains tax or dividend tax, but not both. Loss carryback planning results in the deceased paying no capital gains tax on their shares, but dividend tax instead.[i] Pipeline planning results in the deceased paying capital gains tax on their shares, but the estate won't pay dividend tax when receiving assets from the corporation.

Post-mortem plan	Capital gains tax in terminal return	Dividend tax in the estate
None	Yes	Yes
Loss carryback	No	Yes
Pipeline	Yes	No

Loss carryback planning

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 their FMV immediately before death for tax purposes (assuming there's no spousal rollover). This may create a capital gain on the deceased shareholder's

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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 (i.e., buys back) the shares from the estate and cancels them. The redemption proceeds exceeding the PUC of the shares are deemed to be a dividend for tax purposes.

In most cases, the share redemption also produces a capital loss in the estate because the share redemption creates proceeds of disposition that are 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 proceeds of disposition (which are reduced by the deemed dividend). 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 graduated rate estate, a "GRE"), the estate may elect under subsection 164(6) of the ITA to carry back this capital loss to offset capital gains in the deceased's terminal return.

Using life insurance to fund the share redemptions: the insured share redemption

An insured share redemption is where 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.[ii] Specifically, the corporation is the beneficiary of a policy and receives the death benefit as a consequence of the insured shareholder's death. As a result, the corporation 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. The CDA credit allows the corporation to elect all or part of the deemed dividend(s) arising on the redemption to be 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 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 capital loss.[iii] 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 capital gain realized in the deceased's terminal return. The remaining CDA may be 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 is restricted from carrying back half the capital loss from the share redemption. This is generally regarded as a waste of CDA, unless either the corporation has no other assets to distribute or isn't expected to have assets in the future.

Pipeline planning

The pipeline is the "rogue child" of the two forms of post-mortem planning. Loss carryback planning is expressly enabled by the ITA, in contrast pipeline planning isn't.[iv] As noted, pipeline planning results in

corporate assets distributed to a shareholder at lower capital gains tax rates, but tax policy favours these assets distributed at higher dividend rates. As a result, the post-mortem pipeline carries more tax risk compared to loss carryback planning. To mitigate this risk, tax professionals often obtain an advanced ruling from the Canada Revenue Agency (CRA) before implementing a post-mortem pipeline transaction.

The CRA has issued numerous favourable tax rulings on post-mortem pipelines as long as the taxpayer has the corporation carry on its business or holding of investments for at least a year before the corporate assets are to be distributed to its shareholders.[v] Failing to do this may result in the CRA assessing a deemed dividend when the corporate assets are distributed.[vi] Despite the risks and inconvenience, clients and tax professionals are attracted to pipeline planning as it results in an overall tax burden at a lower capital gains tax rate.

Steps to implement a post-mortem pipeline

How does a post-mortem pipeline work? It's a transaction that has the following steps, using Ben's example above.

1. Ben owns all the shares of **Holdco**, which have a nominal ACB and PUC.
2. Holdco has $1,000 of cash.
3. Ben dies and he's deemed to dispose of his shares at FMV for tax purposes (being $1,000).
4. Assuming Ben's marginal tax rate is 50%, this disposition results in a taxable capital gain of $500 which produces a tax liability of $250.
5. Ben's executor obtains an advanced ruling from the CRA for added assurance that it won't assess a deemed dividend to the estate when undertaking the pipeline.
6. The executor sets up a new corporation (**Newco**).
7. The executor transfers the shares of Holdco to Newco in exchange for a $1,000 promissory note. The ACB of the shares of Newco to the estate is nil.
8. Holdco keeps holding its investment (cash) for at least one year.
9. After the year, Holdco and Newco amalgamate to form **Amalco**.
10. Amalco pays off the promissory note over the course of the ensuing year (see endnote "v" below), resulting in the estate receiving $1,000.
11. The executor distributes the $1,000 to Ben's heirs as directed in his Will.

The result is that tax of $250 was paid in Ben's terminal return and Ben's estate/heirs received the $1,000 from Holdco (via Newco) tax-free.

Using life insurance with pipeline planning

Life insurance can be used in pipeline planning to fund the capital gains tax liability of the deceased. For example, in the case above, Holdco could have purchased a life insurance policy with $250 of coverage on Ben's life. On death, Holdco would receive the death benefit as beneficiary and pay the insurance proceeds to Ben's estate via a capital dividend, or taxable dividend, to the extent that the insurance proceeds credit Holdco's CDA. After paying out the insurance proceeds, the executor could implement the pipeline transaction described above.

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Post-mortem planning options

Whichever post-mortem plan is implemented at death will depend on the circumstances of the deceased. For example, if the corporation owns no life insurance on the deceased shareholder (and therefore no CDA) and has a balance in its refundable tax account then the tax professional might recommend redeeming only enough shares to access the refundable taxes[vii] (loss carryback planning) and pipelining the remaining shares. Or, if the corporation owns enough life insurance coverage on the deceased shareholder to redeem all their shares, then the client's tax professional might recommend doing a full loss carryback. The tax professional would recommend using 100% of CDA on the redemption if the corporation is getting wound-up, or 50% of the CDA if the corporation is to continue operating, leaving CDA for the remaining shareholder(s) to use.

Example

Meet Betty. She's 60 years old and owns fixed-value shares of the family operating company (Opco), which have a total redemption value of $1 million. Assume her marginal tax rate is 50% and her estate's marginal tax rate on non-eligible dividends is 45%.

Betty's advisor recommends that Opco purchases $1 million of coverage to fund a post-mortem insured share redemption. Opco purchases a Canada Life™ universal life policy on Betty's life with $1 million of insurance coverage. Let's assume Betty dies at age 90 and both the policy's death benefit and corresponding CDA credit to Opco is $1 million.

The following table shows tax consequences of no planning, loss carryback planning (no insurance and the 50% solution with insurance) and pipeline planning. This table is intended to highlight Betty's post-mortem tax liabilities, not net estate values.

	No planning	**Loss carryback**		**Pipeline**
		No insurance (for comparison)	With insurance 50% solution	No insurance
Capital gain on final return (post loss carryback)	1,000,000	0	0	$1,000,000
Taxable dividend in estate	1,000,000	1,000,000	500,000	N/A
Capital dividend in estate	0	0	500,000	N/A
Capital loss in estate on redemption	(1,000,000)	(1,000,000)	(1,000,000)	N/A
Capital loss carried back to final return	(1,000,000)	(1,000,000)	(1,000,000)	N/A
Tax on capital gain on final return	**250,000**	0	0	**250,000**
Tax on taxable dividend in estate return	**450,000**	**450,000**	**225,000**	N/A
CDA leftover	N/A	0	500,000	N/A
Value of CDA leftover	N/A	0	225,000	N/A
Total tax liability (combined) $	**700,000**	**450,000**	**225,000**	**250,000**

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[i] Loss carryback planning is also known as “164(6) planning” since it relies on that provision of the *Income Tax Act* (Canada) (ITA).

[ii] 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.

[iii] More specifically, the loss realized by the estate will be reduced by the amount by which the lesser of: capital dividends received on the shares, and the amount of the loss less taxable dividends received by the estate on the shares – exceeds 50% of the lesser of: the amount of the loss otherwise determined, and the individual’s capital gain from the disposition of the shares on death.

[iv] As noted, loss carryback planning is expressly facilitated by subsection 164(6) of the ITA.

[v] CRA past ruling requests on post-mortem pipelines have been favourable provided the taxpayer abides by the criteria set out by the CRA. For example, see 2014-0545531R3. Those criteria are 1) maintain the corporation’s business activity/investment strategy 2) the amalgamation/wind-up may occur no earlier than at least one year after shares transferred to the new pipeline corporation (Newco, in the example) 3) repayment of the note may occur no earlier than one year after issuance of the promissory note 4) repayment of the promissory note should be spread at least a year with the exception that the CRA has ruled to permit immediate receipt of cash to fund taxes 5) the corporation may be wound up thereafter.

[vi] The deemed dividend would result from the application of subsection 84(2) of the ITA. That provision applies where funds or property of a corporation resident in Canada have at anytime after March 31, 1977, been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares in its capital stock, on the winding up, discontinuance or reorganization of its business. Where it applies, the corporation is deemed to have paid at that time a dividend on the shares of that class.

[vii] The taxable deemed dividend from the share redemption implemented in loss carryback planning would allow the corporation to receive a refund of its refundable taxes.