POST-MORTEM ESTATE PLANNING (UNDER COMMON LAW)

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SOLUTIONS

INTRODUCTION

Upon death, the *Income Tax Act* (ITA) stipulates that the deceased is deemed to have disposed of all their capital property for an amount equal to its fair market value (FMV). Such a deemed disposition can result in capital gains and a significant tax liability that can substantially diminish the deceased's estate. However, there are tax relief measures[1] qthat can reduce the tax burden the estate would otherwise have to bear. Without proper planning, though, shareholders of private corporations may be subject to double taxation of their shares upon death.

The text aims to present:

- the issue of double taxation upon death.
- the various post-mortem planning strategies to mitigate or eliminate the effects of double taxation.
- the benefits of using life insurance to finance the payment of the deceased's tax liability while enhancing the value of the estate.

DOUBLE TAXATION UPON DEATH

To benefit from tax relief, several conditions must be met. When these conditions are not met, double taxation occurs: the deceased pays taxes upon death[2], and the heirs could potentially pay taxes upon liquidation of the estate[3].

[1] Refer to the text on taxation upon death on the iA Large Case Solutions website: Tax implications upon death (ia.ca).

[2] On the deceased's final T1 tax return.

[3] On the estate's T3 tax return for liquidation dividends.

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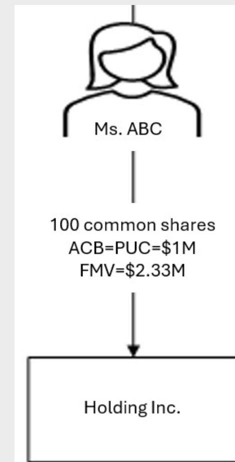
Scenario

To illustrate the situation addressed in this document, let's consider the following scenario:

Ms. ABC was the sole owner of a holding corporation ("Holding Inc.") at the time of her death.

1. Ms. ABC was single and had three children.
2. The only assets of Holding Inc. are investments.
3. Holding Inc.'s shares do not qualify for the lifetime capital gains exemption ("LCGE").



First layer of taxation

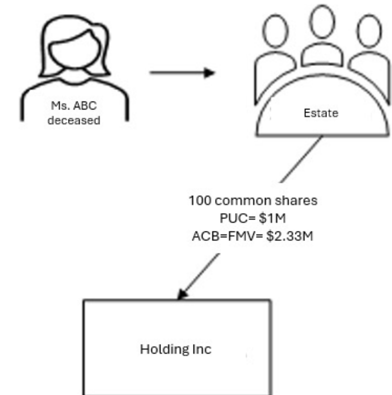
Upon death, the first layer of taxation occurs at the level of deceased on the deemed disposition of Holding Inc.'s shares:

Deemed proceeds of disposition (at FMV)	$2.33M
Less the ACB	($1M)
Capital gain	$1.33M
Tax payable by Ms. ABC	$273,125 [4]

[4] Based on progressive tax rates (Ontario).

Second layer of taxation

After death, the estate owns Holding Inc.'s shares. The ACB of these shares is now equal to the FMV of $2.33M. For the estate to access the liquidity of Holding Inc., the corporation will have to redeem its shares, resulting in deemed dividends[5]. The second layer of taxation therefore occurs at the estate level:



Amount paid to the estate (at FMV)	$2.33M
Less the paid-up capital (PUC)	($1M)
Deemed ordinary dividend	$1.33
Taxes payable by the estate	$429,875 [6]

The net value of the estate that the heirs can receive will be $1,933,915, representing a total tax rate of approximately 26.67%. In summary, a death can give rise to two layers of taxation[7]:

1. Personal: Ms. ABC pays tax on the capital gain realized on the deemed disposition of Holding Inc.'s shares.
2. Estate: After death, Holding Inc. will distribute the funds to the estate, which will pay tax on the taxable dividend.

Post-mortem tax planning aims to reduce the total tax burden and ultimately increase the net estate value. Our analysis is limited to the following tax planning strategies:

1. Loss carrybacks[8] to reduce or eliminate the deceased's tax liability.
2. The pipeline strategy, conversely, to eliminate the estate's tax liability.

[5] The estate may also liquidate Holding Inc. This liquidation results in the realization of a taxable liquidation dividend.

[6] The tax takes into account the tax rates for eligible and ordinary dividends, the dividend refund ("DR") and the general rate income pool ("GRIP"). Investments held by a corporation are taxed at 50.17%. This tax creates a Refundable Dividend Tax on Hand ("RDTOH") account, which corresponds to 30.67% of the "aggregate investment income". The RDTOH can be recovered in the form of a DR if the corporation pays taxable dividends to shareholders. Investment income generated by a corporation taxed at the general rate of 50.17% also creates a GRIP. The GRIP allows corporations to declare eligible dividends, which are taxed at a lower rate than ordinary dividends.

[7] A third layer of taxation (at the corporate level) is possible if, for example, the assets of Holding Inc. need to be sold.

[8] Subsection 164(6) ITA

POST-MORTEM TAX PLANNING

Loss carrybacks

To mitigate the impact of double taxation, the loss carryback provision in subsection 164(6) of the ITA allows for the reduction or elimination of the deceased's capital gain. Consequently, only the estate is taxed on the deemed dividend paid upon the redemption of Holding Inc.'s shares. To this end, subsection 164(6) of the ITA allows:

1. capital losses and terminal losses incurred as a result of the deemed disposition of the shares to be carried back, and
2. treats these losses as losses of the deceased for their terminal tax year.

To benefit from the loss carryback provision under subsection 164(6) of the ITA, the estate's legal representatives must, within one year of the death, file the deceased's amended tax return for their terminal tax year with the Canada Revenue Agency.

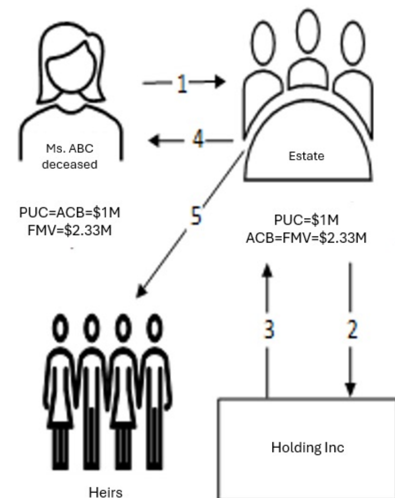
How the loss carryback strategy works

How loss carrybacks work and are calculated

The loss carryback strategy works as follows:

1. Upon Ms. ABC's death, Holding Inc.'s shares are transferred to the estate.
2. The estate liquidates Holding Inc. by redeeming its shares.
3. The redemption of Holding Inc.'s shares results in the estate receiving a deemed taxable dividend of $1.33 million on which it is taxed[9] . A capital loss of $1.33 million is created for the estate since the deemed dividend of $1.33 million reduces the proceeds of disposition of the shares for the estate.
4. The estate's capital loss of $1.33 million is carried back to Ms. ABC, thereby reducing the capital gain realized on her terminal return to $0
5. The net estate value is distributed to Ms. ABC's heirs.

With the loss carryback, the net estate value would be $2,207,040[10], after the estate paid the tax in step 2, which is only the tax on the dividend.



[9] Marginal tax rate of 47.74% for non-eligible dividends and 39.34% for eligible dividends.

[10] Tax rates for eligible and non-eligible dividends, the capital dividend account, DR and GRIP taken into account.

Loss carrybacks: reductions and stop-loss rule

The capital gains of the estate and dividends received by the estate reduce capital losses that can be carried back to the deceased's terminal tax year. However, if, in step 3, the estate receives a non-taxable dividend (called a capital dividend) paid from Holding Inc.'s capital dividend account ("CDA") upon the redemption of its shares, the stop-loss rule[11] may reduce the amount of the capital loss that can be carried back.

According to the stop-loss rule, the estate can only carry back a maximum of 50% of the capital dividend declared to the estate in step 3. This restriction is intended to prevent an estate from receiving a tax-free dividend while realizing a capital loss on the disposition of the paying corporation's shares. This rule thus prevents the creation of a capital loss that does not reflect a real economic loss for the deceased. Consequently, the stop-loss rule reduces the tax payable by the estate and increases the tax payable by the deceased.

To mitigate the impact of the stop-loss rule on the tax payable by the deceased, the corporation can reduce the capital dividend amount reported to the estate by reporting part of it as a capital dividend and the other part as a taxable dividend, up to a maximum of 50% of the dividends. This tax strategy, known as the 50%-50% solutions, reduces solution, reduces the deceased's payable tax and increases the estate's payable tax.

In practice, when implementing a post-mortem tax planning strategy using subsection 164(6) of the ITA, the optimal split between capital and taxable dividends takes into account the tax payable by the deceased, the estate the and stop-loss rules in order to maximize the clients' net estate value[12].

[11] Subsection 112(3.2) of the ITA.

[12] If the deceased has a spouse at the time of death, it may be possible to minimize the impact of the stop-loss rule by implementing the rollover and redemption strategy.

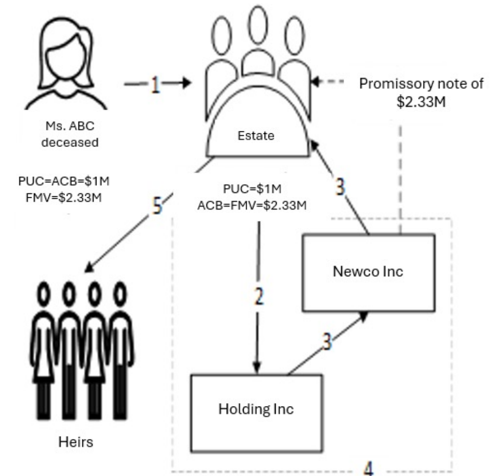
Pipeline strategy

The pipeline strategy aims to eliminate the taxation of the deemed dividend for the estate while maintaining the taxation of the capital gain for the deceased.

The steps of the pipeline strategy

The steps of the pipeline strategy are illustrated as follows:

1. Upon death, Holding Inc.'s shares are transferred to the estate.
2. The estate creates a new corporation, Newco inc.
3. The estate transfers Holding Inc.'s shares in exchange for Newco inc. shares and a promissory note for $2.33 million.
4. The estate liquidates Holding Inc.'s shares within Newco inc. or merges the two corporations.
5. The corporation resulting from step 4 above repays the $2.33 million promissory note and the net estate value is distributed to the heirs.



Several legislative provisions[13] and administrative positions aim to limit the application of the pipeline strategy, such as the gradual repayment of the promissory note over a period of three to five years. Additionally, the costs associated with implementing and maintaining the pipeline strategy may also influence the estate's election.

If the conditions and restrictions are met, the estate will be taxed at the capital gains rate in the hands of the deceased, and the estate will not have to pay any tax to liquidate the corporation. Thanks to the pipeline strategy, the net estate value is $2,056,540, without factoring in the DR, Holding Inc.'s CDA and $2,543,720, taking into account its various tax accounts. However, to benefit from these different tax accounts:

– During Ms. ABC's lifetime, capital and taxable dividends could be declared; or
– Following Ms. ABC's death, the value of Holding Inc.'s assets should increase beyond the amount of the $2.33 million promissory note.

LIFE INSURANCE AND TAX PLANNING

Post-mortem tax planning enhances the estate's value. However, the payment of taxes must be financed. Several financing solutions can be presented to the estate:

1. Refinancing Holding Inc.'s assets requires meeting the financial institution's requirements and increases the estate's liabilities.
2. Selling Holding Inc.'s assets generates more liquidity, reduces the estate's income-generating assets and creates additional tax implications following the disposition.

[13] Sections 84 and 84.1 of the ITA.

Another solution that can be implemented during one's lifetime is to take out a life insurance policy. Life insurance can be an ideal financial instrument for financing the payment of a deceased's tax liability while enhancing the estate's value. Consequently, at age 55, Ms. ABC could have taken out a life insurance policy, such as iA PAR Estate—payable at age 100, with Holding Inc. as the owner, payer and beneficiary:

Premium payments (term)	**45 years**
Coverage period	**Lifetime**
Premium (offset after15 years)	**$7,320.08**
Face amount	**$271,114**
Projected death benefit	**$1,070,931**
Additional deposit option	**$12,680**

Assuming that over 15 years, a total of $300,000 has been invested in life insurance premiums in the policy[14], the characteristics of Ms. ABC's Holding Inc. at age 85 would be as follows:

1. ACB and PUC of shares = $1,000,000
2. FMV = $2,659,500 ($1,747,570 in savings and $911,930 in surrender value)
3. Funds available: $2,904,600 ($1,747,570 in savings and $1,157,030 in death benefits).

The combination of life insurance and post-mortem tax planning further increases the net estate value relative to the FMV of Ms. ABC's assets:

Net estate value		
	Savings only (without insurance)	Savings and life insurance (total premiums of $300,000)
With no planning	$1,933,915	$2,518,465
Loss carryback - (164(6), ITA)	$2,207,040	$2,783,885
Loss carryback - 50 % - 50 % solution	-----	$2,838,200
Pipeline strategy	$2,056,540	$2,543,200

This table illustrates the beneficial effects of life insurance on the net estate value, combined with the implementation of post-mortem tax strategies. In this case, the highest net estate value without insurance (the loss carryback[15]) is lower than the lowest net estate value with insurance (with no planning[16]).

However, the reality may differ depending on the circumstances. In this case, the loss carryback does not take into account the capital dividend and the stop-loss rule. Taking into account the stop-loss rule, the 50% - 50% solution would allow part of the CDA to remain within Holding Inc. By retaining part of the CDA, the net estate value shown above could increase further as Holding Inc. will be able to declare non-taxable dividends after implementing the loss carryback strategy with the tax authorities.

[14]Participating whole life, with an annual premium of $20,000 payable up to age 100 (premium offsets after 15 years) and a basic insurance coverage of $271,114. By increasing the amount invested in life insurance (in the form of premiums), the net estate value increases proportionately due to the favourable tax treatment of life insurance.

[15]$2,207,040.

[16]$2,518,465.

The pipeline strategy presented above does not take into account Holding Inc.'s CDA or RDTOH. If these tax accounts were factored in (as mentioned above in the "Pipeline Strategy" section), the net estate value could increase and surpass the net estate value observed in the case of the loss carryback applying the 50 % - 50 % solution. Additionally, the pipeline strategy allows for the repayment of a promissory note without affecting the CDA balance following receipt of the death benefit. As a result, the amount allocated to the CDA following receipt of the death benefit could increase the net estate beyond the amounts presented above.

CONCLUSION

Following a death, both the deceased and their heirs may be subject to multiple layers of taxation. Post-mortem tax planning mitigates this problem of multiple taxation, significantly increasing the estate's value. Life insurance not only helps finance the payment of the tax liability upon death, but is also a tax-efficient financial instrument that further enhances the net estate value. When choosing appropriate post-mortem tax planning strategies, tax implications are just one factor to consider. Other factors may influence the choice of planning strategy, including[17]:

- The existence of a surviving spouse
- The conditions, restrictions and costs of the pipeline strategy compared to taxation
- Liquidity available to heirs
- Disputes and conflicts among heirs
- Types of return on assets and value fluctuations between the death and the implementation of post-mortem planning
- Other laws and regulations that may affect the estate's value[18].

Therefore, for optimal estate planning, clients should favour a collaborative approach, consulting their tax experts, in conjunction with their financial advisors, to determine the best post-mortem planning for their situation, taking into account taxation and life insurance.

[17] Non-exhaustive list.

[18] For example, laws and regulations governing real estate transfer taxes and consumption taxes.

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