Post-mortem planning for small business owners

As a small business owner, you may save profits inside your corporation that you don't need during your lifetime.[1] At death, double-tax issues can arise for you and your estate without careful planning. This article explores common post-mortem planning techniques to reduce the double tax. Complementing the post-mortem plan with life insurance can further reduce tax and simplify your affairs.

The double-tax issue

As a small business owner, you may save after-tax corporate profits inside your corporation (or a holding company). You may use the money to provide income during retirement or take advantage of the corporate tax deferral. In some cases, you may not need the accumulated savings during your lifetime. Therefore, you need to plan for tax-efficiently transitioning the money to your estate or heirs.

Double tax refers to the potential for the same money to be subject to tax twice. As a small business owner, double tax can arise in several situations under the Income Tax Act (ITA). In particular, double tax may arise when you pass away owning shares in your corporation. To see the double-tax potential, let's look at an example. Assume the shares of your corporation have a value of $1 million. Also assume the shares have a nominal adjusted cost base (ACB) and paid up capital (PUC). At death, the following occurs:

First level of tax on terminal tax return:

- The ITA deems you to dispose of all capital assets at death for income tax purposes. This includes the shares in your corporation.
- The difference between the value of your shares at death and their ACB is a capital gain.
- You claim 50% of the capital gain on your terminal tax return as income. This is the first level of tax. At an assumed rate of 53%:

$1 million capital gain x 50% x 53% = $265,000 tax

Second level of tax in the estate:

- Your estate now owns shares in the corporation worth $1 million. The new ACB of the shares in the estate is also $1 million. The PUC remains nominal.[2]
- However, your estate needs to remove the money from the corporation.[3]
- To remove the money, your estate winds-up the corporation or redeems the shares. This results in a deemed dividend to your estate. The deemed dividend equals the value the corporation distributes to your estate above the PUC for the shares.
- The $1 million dividend to the estate is the second level of tax. At an assumed rate of 47% for non-eligible dividends:

$1 million dividend x 47% = $470,000 tax

Without any further action or planning, the same $1 million is taxed twice. The total tax on $1 million is $735,000; a combined 73.5% tax rate!

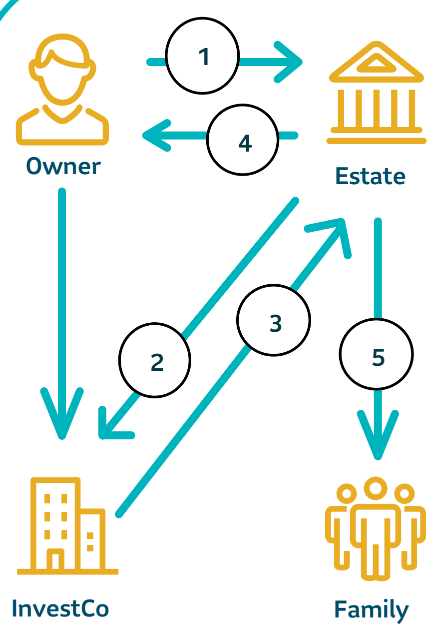
Dividend tax rates across Canada range from roughly 28%-43% for eligible dividends and 37%-49% for non-eligible dividends. Capital gains rates across Canada range between roughly 22% and 27%. Across Canada, the double-tax can result in roughly 60% to 76% tax without proper planning. This is the combined highest provincial or territorial non-eligible dividend tax rate and capital gains tax rate.

Traditional post-mortem planning

Post-mortem planning involves using the rules in the ITA to achieve only one level of tax.

Loss carryback planning

One of the most common methods of reducing the double-tax issue is loss carryback planning. This allows the estate to carry back a capital loss to your terminal tax return. You then use the capital loss to offset some or all the capital gain created by the deemed disposition. Let's look at the example above again to see loss carryback planning in action.



At death

1. Same as above, you have a $1 million capital gain on the deemed disposition of your shares.

After death

2. Your shares transfer to your estate. Your estate now owns $1 million of shares with $1 million ACB and nominal PUC.
3. Your estate winds-up your corporation or redeems the shares. This results in a $1 million deemed dividend to your estate. Because there is a deemed dividend, there is no capital gain in your estate. Under the ITA, the deemed dividend reduces the proceeds of disposition. Your estate has disposed of shares with $1 million ACB for nominal proceeds. This creates a $1 million capital loss in your estate under the ITA.

Loss carryback and distribution

4. If you meet certain conditions, your estate can carry back all or some of the loss to your terminal return. This helps to offset the capital gain in your terminal tax return.
5. Your estate distributes the after-tax money to your family and heirs.

Result: one level of tax at dividend tax rates

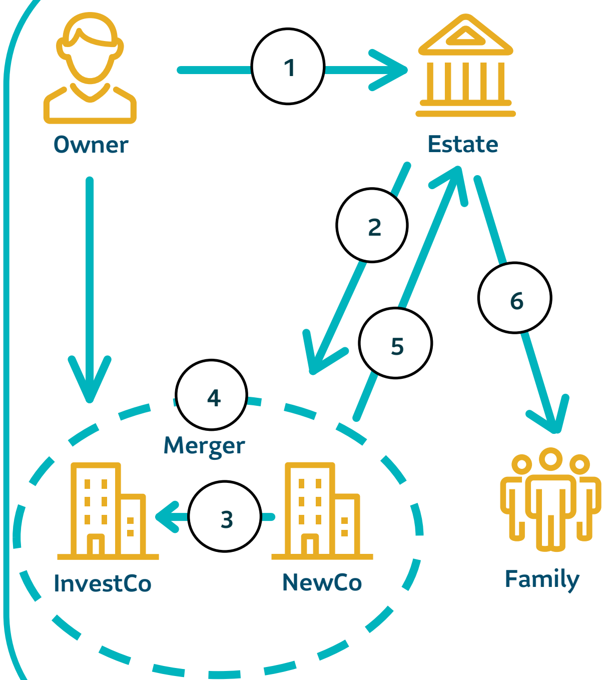
To carry the loss back, your estate must meet certain conditions. These include:

- The estate is a "graduated rate estate" (GRE) as defined in the ITA;
- The estate must carry the loss back within the first taxation year of the estate. This requires your estate to complete the wind-up/redemption within a short period of time; and
- The stop-loss rules (discussed below) may limit the loss available to carry back.

As a result, you may eliminate one level of tax (the capital gain) using loss carryback planning.

Pipeline planning

Loss carryback results in retaining the higher dividend tax rate rather than the lower capital gains tax rate. Given the lower tax rates for capital gains, you may want to explore different post-mortem planning options. One such option is the pipeline plan. There are many different variations to the pipeline plan. Let's look at one version to see pipeline planning in action.



At death

1. Same as above, you have a $1 million capital gain on the deemed disposition of your shares. Your shares in InvestCo transfer to your estate.

After death

2. Your estate now owns $1 million of shares with $1 million ACB and nominal PUC.
3. Your estate creates a new company (NewCo). NewCo buys the shares of InvestCo from your estate for the $1 million ACB. NewCo issues a promissory note to your estate for the $1 million purchase price.

Merger and Repayment

4. Your estate amalgamates InvestCo and NewCo to become one entity. The amalgamated NewCo now holds both the assets and the promissory note.
5. NewCo repays the promissory note of $1 million to your estate. The repayment is tax-free from the assets originally in InvestCo.

Distribution

6. Your estate pays the capital gains tax and distributes the remainder to your family and heirs.

Result: one level of tax at capital gains tax rates

Keep in mind that the above is a simplified illustration of one pipeline process. In practice, implementing a pipeline is complex and requires analysis by your professional tax and legal advisors. Unlike loss carryback, the ITA doesn't contain express provision allowing pipeline planning. Pipeline planning contains many traps for the unwary and may not be available in all situations. If not done properly, the promissory note could be deemed a dividend. This would defeat the purpose of the pipeline and result in dividend taxation. To avoid the deemed dividend, the CRA has administrative positions where they will allow a pipeline.

Based on the CRA's administrative positions and previous commentary, some of the more important aspects include:

- The original corporation's business (in this case InvestCo) will continue for at least one year. This requires your corporation to have business activities (which can include investment activity). However, a pipeline is unlikely if your business has only cash or near-cash as assets.
- The original corporation and new corporation will not amalgamate for at least one year. This prevents you from implementing a loss carryback and pipeline on the same share value.
- The corporation pays off the promissory note gradually over time. This means it will take time to distribute the money from the corporation to your estate. The CRA has given many favourable rulings with gradual repayment. They range from at least one year to several years. However, there is no set amount of time. The CRA states that it depends on each situation.
- The ITA limits using the pipeline strategy to remove money in conjunction with the lifetime capital gains exemption (LCGE). The ITA may deem you to receive a dividend for any amount of the promissory note that relates to a previous LCGE claim on the shares. This prevents you from eliminating all levels of tax.

The above means that pipeline planning is subject to the CRA's scrutiny and potential approval. In some cases, tax professionals get an advanced tax ruling from the CRA to implement a pipeline. This adds cost, time and complexity to the process.

Tax considerations that influence traditional post-mortem planning

Based on the above, you may ask yourself: why wouldn't everyone just do a pipeline plan? Pipeline planning can result in lower capital gains tax rates. However, corporate and personal tax integration is not that simple. Like with the loss carryback discussed above, the ITA contains several other mechanisms to attempt integration, including:

- **Capital dividend account (CDA)**
  The CDA is a notional account that tracks amounts your corporation can pay to you as tax-free capital dividends. Although a complex calculation, this includes:
    - capital dividends received by your corporation,
    - the non-taxable portion of capital gains, and
    - life insurance proceeds less the adjusted cost basis of the policy.

- **Refundable dividend tax on hand (RDTOH) accounts**
  RDTOH consists of two notional accounts that track tax paid on investment income inside your corporation. One RDTOH account tracks the tax paid on eligible dividends your corporation receives. For example, when your corporation invests in a mutual fund that issues a Canadian dividend. Another RDTOH account tracks a portion of the tax paid on other passive investment income inside your corporation. For example, when your corporation receives, interest, rent or royalties. In both cases, your corporation pays the tax to the CRA. Your corporation can then recoup the RDTOH balance when it pays you a taxable dividend as shareholder. For every $2.61 in taxable dividends, your corporation recoups $1 of RDTOH. Recouping RDTOH is subject to ordering rules.

- **General rate income pool (GRIP)**
  GRIP is a notional account that tracks corporate income taxed at the general active business income rate. That is, tax on active business income that didn't benefit from the lower small business deduction tax rate. A balance in the GRIP account allows your corporation to pay you eligible dividends. Eligible dividends benefit from enhanced dividend tax credits. This reduces your personal tax on dividends your corporation pays to you.

All the above require your corporation to declare a dividend. In the context of post-mortem planning, traditional pipeline planning has no dividend paid. However, loss carryback relies on the deemed dividend rules to work. If a large CDA balance exists, you would want to use the balance to declare tax-free capital dividends. Otherwise you lose the CDA under a pipeline plan and instead pay capital gains tax. Or, if you have significant RDTOH balances, your corporation needs to declare taxable dividends to recoup the amount. Otherwise, you lose the tax paid by your corporation to the CRA.

Depending on the available tax pools and notional accounts, integration can influence which plan you choose. Your tax advisors may even suggest a hybrid plan. This involves using loss carryback to maximize your corporation's tax pools and notional accounts with pipeline for the remainder.

Non-tax considerations that influence traditional post-mortem planning

In addition to the tax considerations, there are non-tax considerations to keep in mind. These include:

- **Complexity**. Implementing a loss carryback may be less complex than a pipeline. Pipeline planning involves creating new entities and performing actions over time.
- **Timing and need for money.** You must complete the loss carryback in the first taxation year of the estate. Pipeline planning requires a minimum of 2 or more years to complete. Your estate or beneficiaries may need or expect the money within a set period of time.
- **Graduated rate estate**. Loss carryback provisions are only available to an estate that qualifies as a GRE. The ITA contains specific conditions for an estate to qualify as a GRE.
- **The CRA's current administrative position/changing laws**. Pipeline planning has been subject to the CRA's scrutiny and administrative position of several provisions in the ITA. You may need an advanced tax ruling to assess the risk of the proposed plan. The rules may also be subject to further changes in the future.

Every situation is different and requires a detailed analysis with your professional tax, legal and financial advisors.

Complementing your post-mortem plan with life insurance

Pipeline planning includes time, cost and complexity. You may want to explore an easier way to build your post-mortem plan. One method involves maximizing the CDA using tax-exempt life insurance combined with the loss carryback plan. There are many reasons to own tax-exempt life insurance inside your corporation. For example, it can cover the tax associated with the deemed disposition of your shares upon death.

Tax-exempt life insurance held inside your corporation provides several tax efficiencies to you. First, growth inside the policy is exempt from tax when retained inside the policy. Second, your corporation receives the life insurance proceeds tax free when paid out. Third, the life insurance proceeds minus the adjusted cost basis of the policy creates a credit to the CDA. In general, over time the adjusted cost basis reduces.[4] This means the bulk of the life insurance proceeds can credit the CDA. Your corporation then uses the CDA to declare tax-free capital dividends to your estate or heirs.

By allocating a part of your corporation's savings into tax-exempt life insurance, you can create your own pipeline. You can then maximize the CDA in combination with the loss carryback plan to reduce overall taxes. Your financial advisor can show you illustrations that use tax-exempt life insurance to complement your post-mortem plan.

Stop-loss rules

So, why not put all the corporate surplus in life insurance to maximize the CDA? Loss carryback planning relies on being able to carry the loss back from the estate to your terminal return. The ITA contains specific rules which may limit the ability to carry back the loss from the estate. These stop-loss rules are very complex and require analysis by your tax professionals. The rules restrict you from carrying back the entire loss if you also use the tax-free CDA balance to redeem the shares owned by your estate. Without the stop-loss rules, combining the CDA with a loss carryback could result in no taxes paid at all. If your corporation has a significant CDA balance, you may be subject to the stop-loss rules. In general, stop-loss doesn't apply if the capital dividend is 50% or less than the value of the corporation.

When using life insurance in post-mortem planning, it is important to keep the stop-loss rules in mind. The potential for a large CDA balance may require modified planning. This leads to further strategies including the "50% solution" that your tax advisors may implement. This strategy helps maximize the CDA and reduce the effect of the stop-loss rules.

Summary

Double-tax issues can arise when you accumulate savings in your corporation not needed during your lifetime. However, proper planning can reduce your exposure to double tax. Complementing your post-mortem plan with tax-exempt life insurance can allow you to reduce overall taxes further. Speak with your professional tax, legal and financial advisors to build a plan tailored to your needs.

Published and revised by: Estate & Financial Planning Services
Last revised January 2023

[1] For planning related to corporate surplus needed during your lifetime, see our articles titled "Small business owner remuneration - salary vs dividends", "RRSPs for small business owners", "TFSAs for small business owners" and "The corporate tax deferral – should I save non-registered funds in my corporation or personally".

[2] PUC generally represents capital contributed to the corporation. In this example, there is no increase to the PUC because no capital is contributed to the corporation.

[3] Throughout this article, we assume there is no viable buyer for the shares of the corporation and the company is wound-up to distribute to your heirs.

[4] Other transactions on the policy such as policy loans may affect the adjusted cost basis or CDA credit. In this article, we assume no other transactions occur to the policy that affect the adjusted cost basis or CDA.