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Taxes Upon Death: Know How to Take Advantage of Planning Opportunities

By Pascale Blanchet

Population statistics indicate that assets representing significant amounts will be transferred from one generation to the next over the coming years. Therefore, it is worthwhile to note that certain amendments to tax legislation provide interesting estate planning opportunities as regards such transfers. This bulletin will examine some of these estate planning opportunities, namely those available pursuant to the recent reduction of the tax rate applicable to capital gains. In particular, through the use of examples, we will present two estate planning scenarios which can be used upon the death of a shareholder of a private corporation and their tax consequences for the deceased shareholder and his estate. We will also suggest certain post-mortem planning measures.

Estate Planning - Death

(a) General

The provisions of the *Income Tax Act* ("ITA") provide that, in general, a taxpayer is deemed to have disposed of his capital property immediately before his death for proceeds of disposition equal to the fair market value of that property. However, this rule may not apply in certain circumstances insofar as the individual's capital property is transferred to his spouse or to a trust established for the exclusive benefit of such spouse.

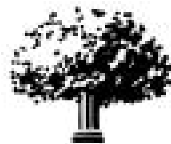
Any person, other than the taxpayer's spouse or a trust established for the spouse's exclusive benefit, who acquires capital property upon the death of a taxpayer will be deemed to have acquired the capital property at a cost equal to the taxpayer's proceeds of disposition, namely, its fair market value immediately before the taxpayer's death. The cost of the property to the estate will be equal to the fair market value of the property immediately before the taxpayer's death.

The major reduction in the capital gains inclusion rate which took place in the year 2000, without a corresponding reduction in the tax rate applicable to dividends, had a significant effect on tax planning strategies.[1] Before the year 2000, if the deceased was the sole shareholder of a private corporation, it was common to have the corporation redeem his shares. We will examine this strategy with the help of an example.

(b) Redemption

Mr. Séguin owns all of the shares of Holdco. The shares have a market value of $15,000,000 and a nominal cost and nominal paid-up capital. Because Holdco is a holding company, the shares of its share capital do not confer the right to the capital gains deduction. Mr. Séguin does not have a spouse.

Mr. Séguin dies in 2002. Assuming that his shares are the only property that has increased in value, he will be deemed to have realized a capital gain of $15,000,000. A few months after Mr. Séguin's death, Holdco redeems all of the shares of its share capital then held by Mr. Séguin's estate.



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1 Following the 2000 Federal Budget and the Economic Statement of October 2000, the capital gains inclusion rate was reduced from 75% to 50%. The actual tax rate for a capital gain realized by an individual subject to the marginal tax rate (48.7%) is currently approximately 24.3% (i.e. 50% x 48.7%) while the actual tax rate for a dividend earned by such an individual is approximately 32.8%, taking into account the dividend tax credit and the 25% gross-up.

The tax consequences of this strategy are as follows:

Taxes upon death	15,000,000 * 24.3% =	$3,645,000
Tax on deemed dividend upon redemption	15,000,000 * 32.8% =	$4,920,000
Less: Capital loss carried back[2]		($3,645,000)
Total taxes		$4,920,000
Total amount received by the estate		$15,000,000
Less: Total taxes		($4,920,000)
Net amount to the estate		$10,080,000

Insofar as the tax rate on dividends is less than the tax rate on capital gains, this strategy is beneficial because the tax is payable by the estate on the deemed dividend upon redemption rather than by the deceased on the capital gain realized upon his death. However, as the second example below demonstrates, since the reduction in the tax rate on capital gains, other estate planning strategies have been developed in order to take advantage of the approximate 8.5% gap between the tax rate on dividends and the tax rate on capital gains.

(c) Transfer to Newco and Winding-Up of Holdco

The facts are identical to those in the preceding example; however, in order to transform the dividend taxable at an approximate rate of 32.8% into a capital gain taxable at an approximate rate of 24.3% following the death of Mr. Séguin, the shares of Holdco are transferred by his estate to a new corporation (Newco). Following this transfer, the shares of Holdco held by Newco have a fair market value, a cost for tax purposes and a paid-up capital of $15,000,000. Holdco is then wound up into Newco.

The tax consequences of this strategy are as follows:

Taxes upon death (Total taxes)	15,000,000 * 24.3% =	$3,645,000
Total amount received by the estate		$15,000,000
Less: Total taxes		($3,645,000)
Net amount to the estate		$11,355,000

The second estate planning strategy allows Mr. Séguin's estate to receive a net amount which is $1,275,000 greater than that received under the first strategy. Thus, from a pure tax point of view, the second strategy is more advantageous.

Post-Mortem Measures

Unlike the estate planning strategy examined above, the following planning techniques are much less complex, but nonetheless result in a significant tax advantage.

(a) Death Benefit

A death benefit is an amount received by a person on or after the death of an employee in recognition of the employee's service in an office or employment. The ITA allows a taxpayer to exclude from his income up to $10,000 of the gross amount of a death benefit. Therefore, the beneficiary of a death benefit can receive up to $10,000 without any tax consequences.

[2] If, during the first taxation year of an estate, the disposition of certain property of the estate received pursuant to the death of an individual gives rise to a capital loss, the liquidator of the estate may elect to consider any portion of the capital loss realized by the estate as a loss realized by the deceased.

Pascale Blanchet has been a member of the Quebec Bar since 2000 and specializes in Taxation

If the deceased is a shareholder of a private corporation, it is recommended that, as a post-mortem tax strategy, an amount of $10,000 be paid by the corporation to the surviving spouse upon the first death and to the children of the deceased upon the death of the last surviving spouse. Thus, the surviving spouse and the children can receive an amount of $10,000 without any tax consequences (i.e. $10,000 for the surviving spouse and $10,000 for the children).

It should be pointed out that the death benefit may not be deductible by the corporation, because the tax authorities could claim that the disbursement was not made in order to earn income. Even so, this post-mortem strategy is still advantageous, because it allows the surviving spouse and the children of the deceased to obtain tax savings of approximately $3,300.

(b) Dividends

The liquidator of the estate of a deceased person must file an income tax return stating the income earned by the deceased between January 1st of the year in which the death occurs and the date of the death. The liquidator may also elect to file a separate return to declare the value of the rights or things of the deceased. The advantage of such an election is that the deceased can benefit from certain deductions and credits on two occasions. The rights or things for which such an election can be made include, among others, dividends which have been declared but have not been paid.

In order to be able to file a separate return upon the death of a shareholder of a private corporation, it is recommended that the corporation declare a dividend before the shareholder's death without, however, paying the dividend. By so doing, certain deductions and credits can be claimed a second time.

Conclusion

Tax planning strategies intended to be used after the death of a shareholder of a private corporation may be unavailable, even if there has been an attempt to implement them after the shareholder's death, if the shareholders' agreement for the corporation has not been properly drafted. For example, certain terms and conditions of a shareholders' agreement—such as the obligation for the deceased shareholder's estate to sell the shares—may prevent the shares from devolving irrevocably to the spouse or to a trust established for the exclusive benefit of the spouse and thereby eliminate the opportunity to take advantage of a tax-free transfer (rollover). Moreover, the constant amendments to tax legislation may provide opportunities to design new tax planning strategies which are more advantageous for the deceased and his estate. Therefore, in matters of estate planning it is important to be flexible when making recommendations and drafting the will, the shareholders' agreement and the other relevant legal documents.

Pascale Blanchet

You can contact any of the following members of the Taxation group in relation with this bulletin.

at our Montréal office
Pascale Blanchet
Philip Nolan
Luc Pariseau
Stéphanie Séguin

at our Québec City office
Jean-Pierre Roy

Montréal
Suite 4000
1 Place Ville Marie
Montréal, Quebec
H3B 4M4

Telephone:
(514) 871-1522
Fax:
(514) 871-8977

Québec City
Suite 500
925 chemin Saint-Louis
Québec, Quebec
G1S 1C1

Telephone:
(418) 688-5000
Fax:
(418) 688-3458

Laval
Suite 500
3080 boul. Le Carrefour
Laval, Quebec
H7T 2R5

Telephone:
(450) 978-8100
Fax:
(450) 978-8111

Ottawa
Suite 1810
360, Albert Street
Ottawa, Ontario
K1R 7X7

Telephone:
(613) 594-4936
Fax:
(613) 594-8783

Web Site
www.laverydebilly.com

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