Death of a Shareholder

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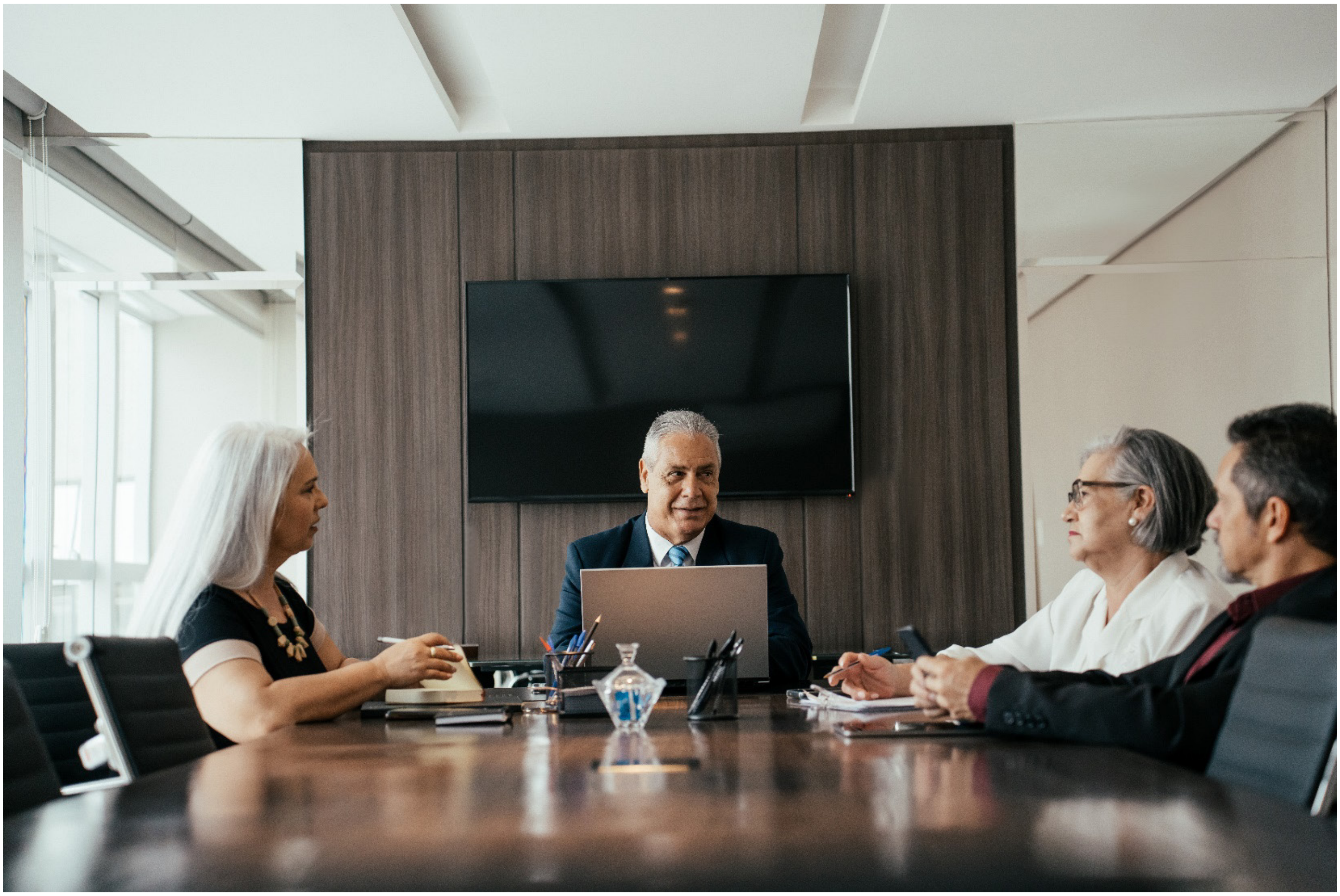

Upon death, there's a deemed disposition of all of an individual's capital property at fair market value, which could lead to capital gains tax if the property has appreciated in value. If an individual owns shares of a private corporation that have grown in value at the time of death, double taxation can arise if amounts are distributed after death from the corporation to the deceased's estate. This report will review the tax consequences of owing private company shares upon death, as well as steps that can be taken both before death, and post-mortem, to reduce potential double taxation.

Double taxation

There are two levels of tax that can arise on the death of a shareholder of a private corporation. The first is tax on a capital gain in the hands of the deceased shareholder, and the second is tax on a dividend received by the estate if amounts in the corporation are distributed to the estate after the shareholder's death.

Deemed disposition on death

On death, for tax purposes, all of your capital property is deemed to be disposed of at its fair market value. This includes any shares you hold in a private corporation. A capital gain or loss will be realized at that time on the difference between the fair market value ("FMV") of the property at the time of your death, and its adjusted cost base ("ACB").[1] You may, however, be able to defer this tax if your spouse or common-law partner[2] (or certain trusts for their benefit), receives the property on your death. In these cases, the property may be transferred at cost rather than FMV, thus deferring any capital gains (and the associated tax liability) until the death of the second spouse or partner, or until that spouse or partner sells the property.

The lifetime capital gains exemption (LCGE) may be available to shelter the first $1,250,000[3] of this capital gain. In order to make use of the LCGE, the shares must be qualified small business corporation ("QSBC") shares. QSBC shares are shares of a Canadian-controlled private corporation in which "all or substantially" (interpreted to mean 90% or more) of the value of the corporation's assets are used in an active business in Canada at the date of the disposition. In addition, either you or someone related to you must have owned the shares for at least two years prior to their disposition, and, during that entire two-year period, more than 50% of the corporation's assets must have been used in an active business in Canada. On death, however, the capital gain arising from the deemed disposition will be eligible for the LCGE so long as the shares qualified as QSBC shares at anytime within the 12 months prior to death.

This report will assume that upon the death of a shareholder, the shares will be deemed to be disposed of at their FMV. This is the first level of tax.

Example:

Jake, an Ontario resident, started up a manufacturing business carried on in a private corporation, Jakeco, by investing a nominal amount of capital. The business was very successful, and Jakeco sold the business to a third party a number of years ago. The sale proceeds were invested inside of Jakeco. Jake did an estate freeze shortly after the sale, where he exchanged his common shares for voting preferred shares that are redeemable for $10 million. New common shares were issued to a family trust, so that any increase in the value of Jakeco after Jake's death would accrue to family members. On Jake's death, he will be deemed to dispose of his shares in Jakeco for $10 million. His spouse has predeceased him and his estate will be left to his children. Assume that Jake's ACB of his shares is nil, as the common shares which he exchanged for the preferred shares had been issued to him for nominal consideration. In this case his capital gain on the shares will be $10 million which is the FMV of the shares less the ACB. Jake's estate will be deemed to have acquired the shares with an ACB of $10 Million. Jake has previously used his LCGE so it is not available to shelter any capital gain arising on the deemed disposition on death.

Capital gains are included in income at a 50% inclusion rate. The $10 million capital gain will be taxed at a rate of 26.76%. This will result in tax of $2,676,000.

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1 If your corporation is the beneficiary of life insurance, the cash surrender value of the policy will be included in the FMV of the shares at the time of your death.

2 In this report, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the *Income Tax Act*, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

3 Under proposals in the 2024 Federal budget, the LCGE will be increased to $1,250,000 for dispositions as of June 25, 2024. The LCGE will be indexed to inflation after 2025.

Tax after death

Sale of shares

If the private corporation is still carrying on a business at the time of the shareholder's death, the estate's beneficiaries may wish to continue to carry on that business. Alternatively, they may wish to sell the business by selling the shares. In this case, the estate, or the beneficiaries, may realize a capital gain if the sale price exceeds the FMV at the time of the original shareholder's death. This is because the ACB that's used for calculating any such capital gain (or loss) will be the FMV of the shares at the time of the shareholder's death.

Share redemption: Deemed dividend to estate

If after the death of the shareholder funds are distributed from the corporation to the estate, a second layer of tax will likely apply. Amounts may be distributed as dividends. Alternatively, the shares may be redeemed. In either case, the estate will likely be treated as having received dividends for tax purposes.

Amounts received on the redemption of shares that exceed the paid-up capital of the shares ("PUC"), which is generally the amount paid to the corporation for the shares on the original subscription, is deemed to be a dividend for tax purposes. This "deemed dividend" could be an eligible dividend, which is taxed at a more preferential rate, or a non-eligible dividend, which is taxed at a less preferential rate, depending on the particular tax attributes of the corporation. It is also possible that some of the dividend could be a non-taxable capital dividend, especially if the corporation is the owner of a life insurance policy and receives a death benefit on your death.

Share redemption: Disposition in estate

Because the redemption of the shares is a disposition for tax purposes, it must also be determined whether or not a capital gain or loss will arise. For purposes of calculating this capital gain or loss, the amount of any deemed dividend is deducted from the proceeds received on the redemption. In other words, the proceeds of disposition used in calculating the gain to the estate on the disposition would be the FMV of the shares less the amount of the deemed dividend. The ACB of the shares is deducted from this adjusted proceeds to determine any capital gain or loss.[4] Because of the original deemed disposition on your death, the ACB of the shares to the estate is the FMV of those shares at the date of death.

Example:

Continuing with the example above, Jake's estate redeems the preferred shares. Because Jake paid a nominal amount to the corporation when he subscribed for the common shares that were exchanged into the preferred shares, the PUC of the preferred shares was nominal and we will assume it is nil. As such, the estate will be deemed to receive a dividend for the entire $10 million received on the redemption of the shares.

If this dividend is an eligible dividend, it will be taxed at a 39.34% (Ontario's top tax rate), resulting in an additional tax of $3,934,000. If instead the dividend is a non-eligible dividend, the tax rate will increase to 47.74%, and will result in $4,774,000 of tax.

It should also be determined if a capital gain or capital loss arises at the time of the redemption. The proceeds of disposition will be the $10 million received on the redemption, less the deemed dividend of $10 million, for a revised proceeds of nil. As the ACB will also be $10 million, the result will be a capital loss of $10 Million. This capital loss, however, cannot be used to offset the income inclusion from the deemed dividend.

Assuming that the capital gain arising from the deemed disposition of shares on Jake's death results in $2,676,000 of tax (as computed above) in Jake's final tax return, and if the deemed dividend is an eligible dividend, the combined tax bill for these two levels of tax will be $6,610,000. It could be as high as $7,450,000 if the deemed dividend is a non-eligible dividend. The effective tax rate on this combined amount of tax could be as high as 74.50%, which is effectively double taxation.

[4] Note that any capital loss, however, cannot be used to offset the income inclusion from the deemed dividend.

Post-mortem planning

There are two common strategies to mitigate this double taxation issue.

Loss-carryback

One way to reduce any double taxation is to offset any capital loss arising in the estate on the redemption of shares, against the capital gain arising resulting from the deemed disposition upon death. Under this plan, if the capital loss eliminates the capital gain, the only tax remaining would be on the tax on the deemed dividend arising on the share redemption. The estate would essentially pay the tax at the relevant dividend tax rate on the amount that the shares have increased in value, and there would not be any capital gains tax.

Historically, the tax rules permitted this loss carryback and offset to occur where the estate qualified as a graduated rate estate[5], but only if the loss was realized in the estate in its first taxation year, and an election to apply the loss to the last tax year of the deceased was made, in the estate's first taxation year. This was often difficult to accomplish from an administrative perspective due to the short time frame. Delays in implementing a share redemption could occur, for example, if there is a delay in the time to obtain probate of the applicable will. This could certainly occur in the event the will is contested.

In 2024, amendments were proposed to the tax rules that will now permit capital losses realized in the first three taxation years (vs. only the first taxation year) of a graduated rate estate to be carried back to the last taxation year of the deceased. This makes it much easier from an administrative perspective for the shares to be redeemed, and the capital loss recognized in the required time period to be carried back to the year of death.

Example:

Continuing with our example of Jake, if the capital loss of $10 million realized on the redemption of the preferred shares of Jakeco by the estate was carried back to offset the $10 million capital gain realized on Jake's passing, then the only tax remaining would be that levied on the deemed dividend of $10 Million on the share redemption. This would mitigate the double taxation issue, and Jake's estate would be left with one layer of tax levied at a rate of either 39.34% (or 47.74%), depending on whether the deemed dividend is eligible or non-eligible. Total tax will be either $3,934,000 or $4,774,000. Note that this is 13% (or 21%) higher than the 26.76% tax rate [$2,676,000] that would have applied to the capital gain realized on the deemed disposition on Jake's death.

Tax-free dividends

When a capital dividend[6] is paid from a corporation's capital dividend account ("CDA"), the dividends are tax-free to the receiving shareholders. Capital dividends can be paid when there is a positive balance in a corporation's CDA . The non-taxable portion (50%) of capital gains, is added to the CDA, and the CDA will be reduced by 50% of capital losses. In addition, where a corporation receives the death benefit of a life insurance policy, the death benefit, less the adjusted cost basis of the policy is added to the CDA.[7] As such, where a corporation owns a life insurance policy on the deceased's life, all or a portion of the death benefit received by the corporation on the shareholder's death can be paid out as a tax-free capital dividend to the estate.

Whether the deemed dividend on the redemption of shares by your estate is an eligible dividend, a non-eligible dividend or a non-taxable capital dividend will depend on the tax profile of the redeeming corporation at the time it is paid. Declaring some of the deemed dividends arising as capital dividends could reduce the overall

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5 A graduated rate estate is generally an estate in the first 36 months after death.

6 The capital dividend account is a notional account of the corporation which tracks the non-taxable portion of capital gains less allowable capital loss, the tax-free death benefit associated with a life insurance policy, among other things. An amount equal to the CDA balance at any point in time can be distributed to shareholders as tax-free capital dividends from a private corporation.

7 The simplified formula for the ACB of the policy is the portion of the premiums paid relating to the investment component of the policy (the total premiums paid, less the cumulative Net Cost of Pure Insurance (NCPI)). The life insurance provider should be contacted for information regarding the ACB.

tax bill; however under a special stop-loss rule, the payment of dividends could result in a portion of the capital loss realized on the share redemption being denied for tax purposes if the amount of the capital dividends is too large compared to the amount of the capital gain arising on death. Due to this potential issue, the amount of capital dividends declared will be important.[8]

Example:

Assume that Jakeco owns a $2 million life insurance policy on the life of Jake, and after Jake's death, there is an addition to the CDA of $2 million from the death benefit received. Jakeco will increase the PUC of the shares by $2 million, and this will cause a deemed dividend to be declared in the amount of the death benefit[9] ($2,000,000), which it will designate as a capital dividend. This deemed dividend, being a capital dividend, will be received by the estate tax-free. The preferred shares will then be redeemed for $10 Million. As the PUC of the shares will have increased to $2 million, the deemed taxable dividend now arising on the redemption will be $8 million ($10 million proceeds less $2 million PUC.) The adjusted proceeds will now be $2 million, resulting in a capital loss of $10 million[10], with no part of it being denied. It will be used to offset the capital gain arising on Jake's death.

The only tax remaining will be that on the taxable dividend of $8 million. Tax of $3,147,200 will arise if the dividend is an eligible dividend, and tax of $3,819,200 will arise if the dividend in a non-eligible dividend. These amounts are lower than if the entire $10 million was received as a taxable dividend.[11]

Pipeline strategy

The second way to eliminate the double taxation is to undertake what is commonly referred to as a "pipeline" transaction. This involves the estate incorporating a new corporation ("Newco") and transferring the shares in the original corporation to Newco. In exchange for the shares Newco receives from the estate, Newco will issue a promissory note to the estate for the value of the original shares. Newco will then own the original shares held on the death of shareholder. This share transfer can occur on a tax-free basis.[12]

Newco and the original corporation can then amalgamate. The amalgamated corporation can repay the promissory note using the property that was held in the original corporation. If the pipeline is structured properly, tax should not arise on the repayment of the promissory note.

As a result of the pipeline, the property in the original corporation can be transferred to the estate, with the only layer of tax being the capital gain resulting from the deemed disposition on death. Generally, a pipeline strategy can take upwards of two years to implement.

Example:

Assume that instead of Jake's estate receiving distributions directly from Jakeco, it instead uses the pipeline strategy. Newco is incorporated by Jake's executor. The estate transfers the preferred shares in Jakeco to Newco, and receives in return a promissory note for $10 million. Jakeco and Newco ultimately amalgamate, and the promissory note is repaid by the amalgamated corporation to Jake's estate. As this occurs on a tax-free basis, the only tax arising is the $2,676,000 tax on the capital gain arising on the deemed disposition of shares on Jake's death.

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8 So long as the capital dividends do not exceed 50% of the capital loss realized on the share redemption, then the loss should not be denied.

9 So long as the relevant corporate law governing Jakeco permits, the PUC of the shares will be increased, which will result in a deemed dividend. This will also increase the ACB of the shares.

10 To determine the amount of proceeds for purposes of calculating the capital gain or capital loss, the redemption amount of $10 million will be reduced by the deemed dividend of $8 million for $2 million proceeds. As the ACB will be $12 million, because of the previous PUC increase, the capital loss will be $10 million.

11 Keep in mind, however, that allocating the CDA balance created by the insurance death benefit to the preferred shareholder means that it's not available later on to use to pay to the common shareholders. This means that the planning has potentially shifted the tax burden of taxable dividends to the common shareholders from the preferred shareholder.

12 This transfer typically occurs pursuant to the provisions of subsection 85(1) of the Income Tax Act.

Loss carry-back or pipeline?

The decision whether to use a loss carry-back or pipeline strategy will be determined after the death of the shareholder. There are a number of factors that the estate representative should consider in this decision.

As a loss carry-back strategy generally results in one layer of tax at dividend tax rates, and the pipeline results in one layer of tax at capital gains tax rates, the two after-tax results should be compared. The tax rate on capital gains is generally lower than the tax rate on dividends, even when the dividends can be designated as eligible dividends. As such, a pipeline strategy generally results in a lower overall tax rate, unless a sufficient portion of dividends can be designated as tax-free capital dividends, or the deemed dividend results in a refund to the corporation of some taxes that were previously paid on investment income. The tax attributes of the corporation will need to be reviewed to determine the nature of dividends paid, and the amount of any refundable taxes available. That's why in some cases, the loss carry-back strategy is preferred when there is a substantial amount of refundable dividend tax on hand (RDTOH) in the corporation that can only be recovered through the payment of a dividend.

In addition, the cost of a pipeline transaction should be compared to a loss carry-back. As a pipeline will involve the incorporation of a second corporation, as well as an amalgamation, this will generally result in higher professional fees than a straightforward loss carry-back plan.

Finally, the carry-back of losses is specifically provided for in the Income Tax Act. The desired tax result from the pipeline strategy, however, relies on the administrative position taken by the Canada Revenue Agency in numerous technical interpretations and advanced tax rulings. As such, the pipeline strategy is generally considered to be of higher risk than the loss carry-back plan.

Estate freeze

An estate freeze may be another way to eliminate or reduce the double taxation at death. A freeze is a transaction undertaken to pass future corporate income and growth to other family members. In the typical estate freeze transaction, the existing value of private company shares is locked into (or “frozen” in) new preference shares that are issued to the original shareholder(s). In the future, the shareholder can then draw upon this frozen value by redeeming these preferred shares and receive cash. Any future growth of the corporation accrues to the new common shares issued by the corporation. In many estate freezes, a family trust is used to hold these new common shares for the benefit of family members, such as children or grandchildren, who can then obtain future income and growth from the corporation. With this planning, care must be given to the Tax on Split Income (“TOSI”) rules which limit the opportunities to split income among family members who are not actively involved in a business. For further information, please see our report The CCPC tax rules.

Tax on appreciated assets in the corporation

Finally, keep in mind that there could be corporate tax payable on capital gains on appreciated assets in the corporation when these assets are liquidated in order to make distributions (e.g. pay dividends) to the estate. It may be possible to minimize this other layer of tax should the pipeline strategy be used. This is accomplished by “bumping up” the ACB of certain appreciated assets in the corporation to their FMV when the corporation is amalgamated with the Newco to form the new amalgamated corporation.[13]

[13] This is accomplished pursuant to paragraph 88(1)(d) of the Income Tax Act. Not all assets can have the ACB increased in this manner. The requirements for paragraph 88(1)(d) to apply are complex and professional tax advice is required for this planning.

Conclusion

For individuals who pass away owning shares in a private corporation, the issue of multiple layers of taxation on death is real. One of the most important steps that can be taken during lifetime to deal with this issue is to have a properly drafted will that permits the estate representatives to take steps necessary to minimize this double tax. Shareholders might consider an estate freeze at some point in order to limit tax exposure on death, and pass growth in the corporation to the next generation. Permanent life insurance can also be considered to fund some of the tax arising. As discussed above, in many cases, insurance proceeds can be distributed as a tax-free capital dividend to the estate. Finally, tax advisors should be consulted to advise on the best strategy to eliminate (or at least minimize) the extent of double (or, in some cases, triple) taxation.

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