



Death takes no tax holiday – Private corporation profits vulnerable

Successful business people who are fortunate to be shareholders in a private corporation often find themselves in an enviable position as their careers begin to wind down. The result of many years of hard work, and dutiful obedience to their accountants' tax savings strategies, is that they enter their twilight years having created a company with a significant market value. However, they then become faced with a problem. The government will one day (usually at the shareholder's death) want to tax this accumulated value and the businessperson's estate had better have the cash available to pay it. Luckily for them, a well thought-out life insurance plan can save the day. How these business people arrived at this juncture is simple.

Our Income Tax Act actually encourages corporation income accumulation over personal accumulation. For example, the income tax rate on business income for private corporations ranges between 22-31 per cent while the average tax rate for an individual in the highest tax bracket is about 48.6 per cent. Therefore, individuals who have incorporated businesses tend to minimize the income they receive from their company and accumulate the profits within the company's books, as it is more tax efficient. By doing so, they are able to minimize their taxable income over the years and boost their long term savings and company's market value. As they enter their estate-planning phase, they are faced with a dilemma. What are the potential tax implications of this asset at my death?

Actually, besides their home and their RRSP the company often ends up being their most valuable asset and few of them realize the potential tax implications on this asset. It is a bit of a head in the sand mentality or ignorance is bliss but the reality of the matter is that they will be hit hard at their death without proper planning.

What happens at death is that the shareholder is deemed to have disposed of his assets immediately prior to death. In the case of these shareholders, from

a taxation point of view, this essentially means that they have sold the business the day before they died. The Income Tax Act treats this sale as a capital gain (or a capital loss, which is less often the case) and, as such, is subject to the normal capital gains inclusion rate on one's terminal tax return.

To calculate a capital gain the business owner takes the market value of the property at the date of death, or the sale price, less the adjusted cost base(ACB) which represents the original and subsequent cost of acquiring the property. Often this ACB is low or next to zero so the entire value of the company is deemed to be a capital gain. The current capital gains inclusion rate in Canada is 50 per cent. For example, say a business had a gain of \$1 million, \$500,000 would be subject to tax and approximately \$243,000 of taxes would become payable by the estate of the taxpayer (at a 48.6 per cent marginal tax rate).

This would be fine and dandy if the estate had the cash available. What is usually the case is the deceased has been accumulating all of his or her wealth within their companies at a tax-preferred rate, and the estate does not have any liquidity. This means the executors of the estate are left scrambling to find the cash to pay these taxes. This can have a devastating impact on the surviving business and the heirs and/or surviving shareholders' ability to continue running it. Where can they find this cash?

According to tax law, the estate basically has the following choices, none of which is very palatable from a tax point of view. First, they can pay out a salary to the surviving shareholders who, then in turn, pay the taxes. However, this income may be subject to the highest marginal tax rate plus the company may not even have that kind of cash available. Secondly, they can pay out a dividend but once again the company might not have the cash. In addition, in order to receive the net after-tax amount they need, they might have to pay out an even larger amount. Thirdly, they could take out a loan from the company to pay these taxes but if it is not repaid within 12-24 months it is considered as income and they are back to square one, tax-wise. One truly practical solution is through the use of life insurance and having the proceeds paid out through the Capital Dividend Account.

The Capital Dividend Account is a "secret compartment", within the Income Tax Act that allows for insurance mortality benefits to be paid out tax free in

the form of a dividend. In our example above, with proper planning, this business person's corporation would have taken out approximately \$243,000 worth of life insurance on his or her life and made the corporation the beneficiary of the policy. At death, the corporation receives the insurance proceeds on a tax-free basis and a large portion falls into the capital dividend account, out of which the estate can receive a taxfree dividend. The estate is still faced with the \$243,000 tax bill but now would have the liquidity to easily pay the tab while keeping the business in tact and possibly thriving for generations to come.

There really is no better solution for those business people in this situation as long as they are insurable. The sooner they recognize this potential problem and get the insurance in force, the better, as people's health conditions deteriorate in later years and then the insurance is no longer an option.

Due to simple ignorance of the potential tax issues at death for small business owners (and big ones too, by the way) many successful businesses are severely strained or even wiped out at the owner's death, where a little forward planning may have allowed the business to continue. If you are a business owner, or are related to one, you can start your planning today.

The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPF. Insurance products are offered through RBC DS Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC DS Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC DS Financial Services Inc. RBC DS Financial Services Inc. is licensed as a financial services firm in the province of Quebec. ®Registered trademark of Royal Bank of Canada. Used under licence. RBC Dominion Securities is a trademark of Royal Bank of Canada. Used under licence. © Copyright 2005. All rights reserved.