



# THE JEWISH COMMUNITY FOUNDATION OF MONTREAL

## PROFESSIONAL DEVELOPMENT SEMINAR 2006

POST-MORTEM TAX PLANNING -  
THINGS TO CONSIDER AFTER THE SHIVA

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### **STREAMING OF ASSETS TO VARIOUS BENEFICIARIES**

1. The executors usually have the power to decide how the assets of the deceased are to be distributed amongst the beneficiaries. Oftentimes the highly appreciated assets are allocated to the surviving spouse to allow for a tax-free rollover of such assets. However, in valuing the assets received by the spouse, there should be a downward adjustment for the assets received by the spouse that are subject to future tax in the spouse's hands (on disposition or on death). Consider for example an estate with \$1 million of assets that is divided equally amongst the children and the spouse. Assume further that making up the \$1 million is an asset that originally cost \$100,000 and is now worth \$400,000 with the balance of \$600,000 in cash. If the spouse is allocated the asset worth \$400,000, the spouse will have a future tax liability on this asset of approximately \$75,000 (the capital gains tax on the \$300,000 of gain). Typically, assuming there is no immediate plan to dispose of such an asset, in valuing this asset, there should be a deduction for part of the future taxes payable. In this case, it would be reasonable to deduct \$37,500 (approximately equal to 50% of the future tax liability) so that for purposes of the distribution, the estate would be deemed to only be worth \$962,500 with the spouse having to receive an additional \$118,750 in cash to make up her 50% share.

### **MULTIPLE RETURNS**

2. The Tax Act allows for more than one type of income tax return to be filed for the year of death on behalf of the deceased. The filings of more than one return is beneficial as tax at the low brackets can be multiplied by the number of returns. The first type of return is the ordinary return for income of the deceased from January 1<sup>st</sup> of the year of death to the date of death. The second is with respect to "rights or things" which may be reported on a separate return. Generally, "rights or things" include items of income which have been earned and are receivable as at the date of death but which have not been collected (such as a matured uncashed bond coupon and unpaid salary or commissions if such wages or commissions relate to pay periods ending prior to the

date of death). Declared and unpaid dividends are also rights and things if the ex-dividend date is prior to the date of death. (It is also possible to transfer the tax liability for rights and things to the beneficiaries who receive such rights or things. This must be beneficial if the tax rates of the beneficiaries are low.) A separate return can also be filed where a taxpayer operated a business and an election was made to use an off-calendar fiscal year.

### **MULTIPLE LOW RATES**

3. A testamentary trust is considered to be a separate taxpayer. Therefore, it may be possible to "income split" by leaving income in the estate. If the will provides for multiple trusts (say one trust for each child) then further income splitting can be achieved by leaving some of the income in such trusts on a going forward basis. Note this type of planning may involve subsections 104(13.1) and (13.2) of the *Income Tax Act* ("ITA").

### **GENERAL RENUNCIATION**

4. In certain cases, it may be beneficial for the heirs to renounce the estate in favor of one individual (usually the spouse to permit a full rollover). The renunciation must be general and not specific. Care should be taken that the renunciation will not result in unwanted gifts to other heirs (such as siblings of the deceased) where there is an intestacy. Such a plan is usually used where there are highly appreciated assets and the people who will renounce can be satisfied that they will ultimately receive the assets on the death of the spouse. This can be assured if the spouse creates an alter-ego trust with the assets received from the estate.

### **PLANNING WHERE THERE ARE U.S. BENEFICIARIES**

5. If the deceased held shares in a private company which has surplus which if distributed will give rise to refundable tax, and surplus that can come out as CDA, the

estate can usually reorganize the capital of such a company prior to any distributions so that the CDA shares are held by the Canadian beneficiaries and the taxable surplus shares are held by the non-resident beneficiaries. This will avoid tax on the CDA dividends (which otherwise would result in a withholding tax if paid to non-resident beneficiaries) and generally lower tax on the taxable dividends (as withholding tax is usually cheaper than the tax payable by Canadians on taxable dividends). Care must be taken to avoid the anti-avoidance provision contained at section 212(1)(c)(ii) ITA.

#### **ALLOCATION OF U.S. ASSETS TO U.S. BENEFICIARIES**

6. Where there are Canadian and US beneficiaries, it is often beneficial to allocate the U.S. assets to the U.S. beneficiaries so as to avoid cross-border problems. For example, if the deceased owned shares of a U.S. private corporation, such shares are usually best left to the U.S. beneficiaries.

#### **CHANGING JURISDICTION OF ESTATE SINCE QUEBEC'S RATE OF TAX ON DIVIDENDS IS CONSIDERABLY HIGHER THAN IN OTHER PROVINCES**

7. Steps may be taken to transfer the residence of the estate to another province outside of Quebec. This is easy where some of the trustees already reside outside of Quebec and it is more difficult when all of the executors reside in Quebec (although possible). Obviously, this depends on the type of income to be earned by the estate. Usually, it works well where there is a private company that has refundable tax available to it and in order to access the RDTOH, large taxable dividends must be paid.

#### **VOLUNTARY DISCLOSURES**

8. If there is undeclared off-shore money in the estate, it is relatively easy to make voluntary disclosures on behalf of the deceased. This should be strongly considered as if a disclosure is not made, there will be personal liability to the executors and the offshore funds may cause problems to the beneficiaries of such accounts in the future.

The current cost for a voluntary disclosure is approximately 40% of the offshore capital. There is also a distinction between tax paid off-shore money and monies off-shore that were never subject to any Canadian tax.

### **DEATH BENEFITS**

9. Don't forget that where the surviving spouse receives up to \$10,000 as a death benefit from the deceased's employer (including an employer who is a closely-held corporation), the said amount is not taxable to the recipient spouse.

### **SECTION 164(6) ITA PLANNING**

10. A detailed review of the post-mortem tax planning utilizing section 164(6) ITA is beyond the scope of this speech. In general terms, however, an estate can make an election to offset capital losses realized in the year subsequent to death against the capital gains that were reflected in the deceased's tax return. This is most often used in the context of holding companies owned by the deceased, which holding companies hold appreciated assets. Oftentimes, the assets of the holding company are sold, to trigger a gain, which in turn will result in RDTOH and CDA. The holding company is then wound up which will usually trigger a loss which can offset the capital gain on the deemed realization of the shares on the taxpayer's death. This will therefore result in a single level of tax as opposed to a tax on death (being the capital gain on the shares) and a possible second round of tax when the appreciated assets in the holding company are sold. This is particularly true of assets that cannot be the subject of the "bump" under section 88(1)(d) ITA (such as real estate). We have found that because of the tax rate differential between capital gains (24%) and dividends (as high as 36%) where there is a company with appreciated assets that can be the subject of the "bump", it may be better to have the estate pay tax on the capital gain. Then the heirs roll over the shares of the company with the appreciated assets to a new company (Newco) and wind-up the existing company into Newco, electing under section 88(1)(d)

*ITA*. Thereafter, the beneficiaries can access an amount equal to the stepped-up value of their shares without tax.

### **THE 50% SOLUTION**

11. Where corporate insurance is received, and "grandfathering" is not available, only one-half of the deemed dividend arising on the redemption of shares by the company is elected as a capital dividend. The remaining portion of the dividend is taxable. This allows all of the capital loss realized in the estate's first taxation year to be carried back against the capital gain arising in the year of death. It also leaves a capital dividend account credit for the remaining shareholders. This is a complicated "solution" but definitely is worth the effort in most circumstances. Assume for example that there is a deemed disposition of shares of a holding company worth \$1 million and an ACB of \$0. Assume further that the holding company receives \$1 million of insurance proceeds on the death of the deceased. Using the "50% solution", a capital loss is created of \$1 million by redeeming shares of the holding company within the year subsequent to death. Therefore, the tax to the deceased shareholder is \$0. The estate will receive a \$500,000 CDA dividend and a \$500,000 taxable dividend which will result in tax to the estate of approximately \$170,000. There will also be a remaining CDA credit for the beneficiaries of \$500,000 (which itself is worth approximately \$170,000). If grandfathering applies, there is no tax to the deceased shareholder or the estate. If grandfathering does not apply, and the 50% solution is not utilized (but the entire CDA is used to redeem shares), the deceased shareholder would have a tax of approximately \$125,000 on the deemed capital gain with no amount available as a CDA credit.

## A WORD ABOUT TAX RATES

As surprising as it may seem, the recent Quebec Budget actually increases the Quebec tax rate on dividends received by Quebec individuals. The tax rate is increased by 1.1% for "eligible dividends" (that is dividends from public corporations and dividends from private corporations out of surplus that has been taxed at the high corporate rate) and 3.5% for "non-eligible dividends" (presumably dividends from private corporations out of surplus that has been taxed at the low corporate rate and from surplus that has arisen from investment income where there is refundable tax).

The Quebec Budget was in reaction to the federal announcements (made by the Martin government) prior to the election but implemented in the Conservatives' May 2<sup>nd</sup> Budget. The new Federal Budget decreases the federal tax on eligible dividends by 4.2%. Therefore, the net tax on eligible dividends is reduced from 32.8% to 29.7% which still means there is a bias in favour of distributions from income trusts as opposed to the receipt of dividends from a public corporation. For example, if \$100 is taxed at the general corporate rate of 31%, and then an individual pays 29.7% on the \$69 of surplus that is dividended out to him or her, the net retention by such individual will be approximately 48.5% versus approximately 51.8% on the distribution from an income trust. (It should be noted that because of the timing of the Quebec Budget, eligible dividends paid in the period January 1<sup>st</sup>, 2006 to March 23<sup>rd</sup>, 2006 are only subject to a tax rate of 28.6%, since Quebec only increased its tax on such dividends after its Budget date.)

For non-eligible dividends, the tax rate for Quebec individual recipients has risen from 32.8% to 36.3% (for dividends paid after March 23<sup>rd</sup>).

The expected results from these changes are as follows:

- Taxpayers will attempt to convert what otherwise would be dividends, taxed at approximately 36.3%, to capital gains which are taxed at 24.1%.

- Steps will be taken to shift dividends to low tax provinces (such as Alberta) via the utilization of trusts.
- The elimination of private holding companies in many situations. It should be noted that if the true tax rate of a holding company is 25% (net of refundable tax) and the resultant 75% is taxed at 36.3%, the individual would be left with 47.7% as opposed to approximately 51.8% if the investment income was earned directly by the individual. Also, holding companies are subject to tax on capital.

It is unclear as to how the legislation will treat dividends paid out by a private corporation. Consider the situation where a Canadian-controlled private corporation has earned low rate active business income and investment income (both considered "ineligible") as well as high rate active income (which would be considered "eligible"). On the payment of a dividend out of this corporation's surplus, would the dividend be considered to first emanate from the "eligible" or the "ineligible" pool? Obviously, this will matter greatly as the rate differential will be 7.6%.