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Trapped surplus in a corporation

How did we get here? How to use life insurance to get it out?

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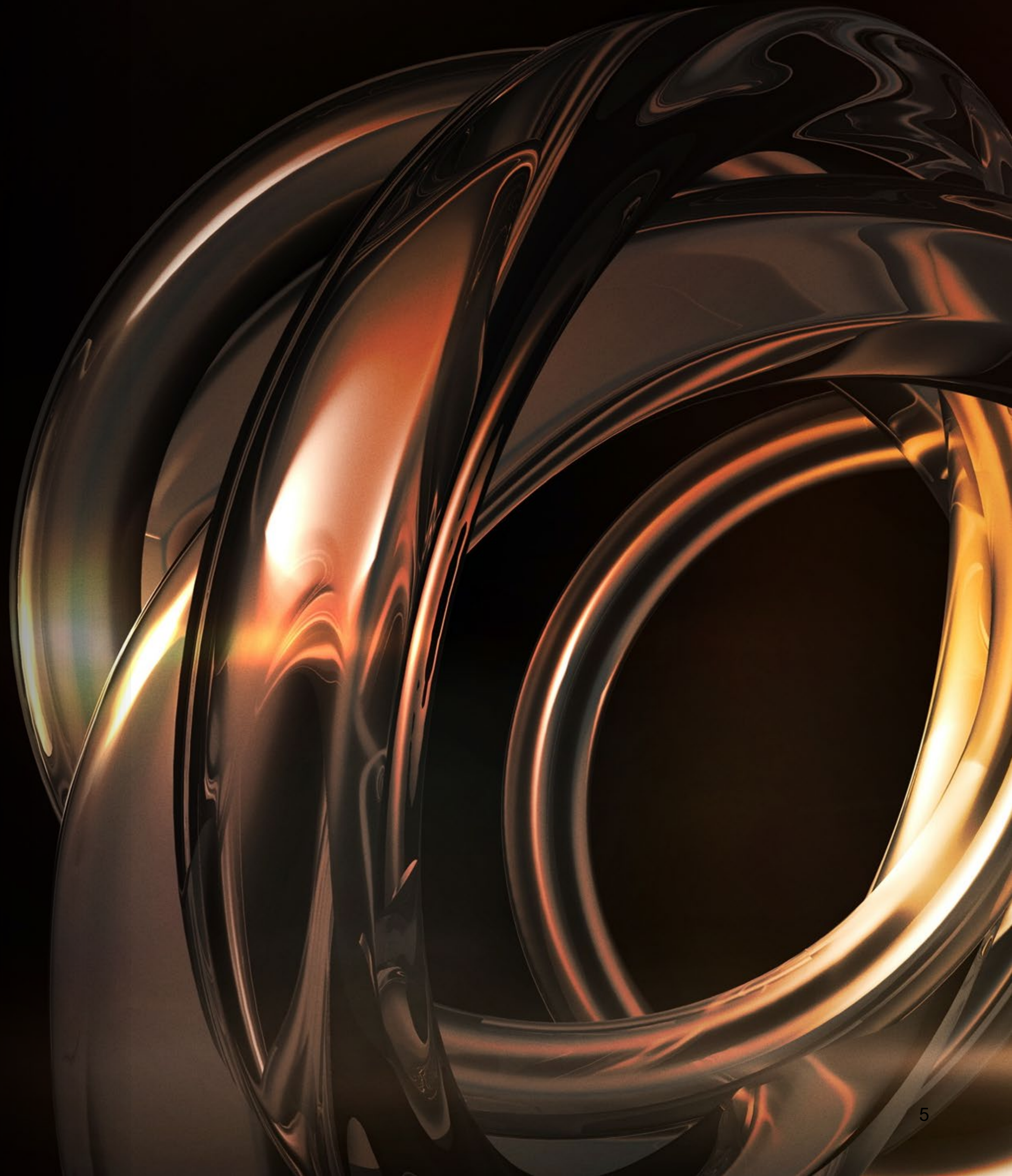
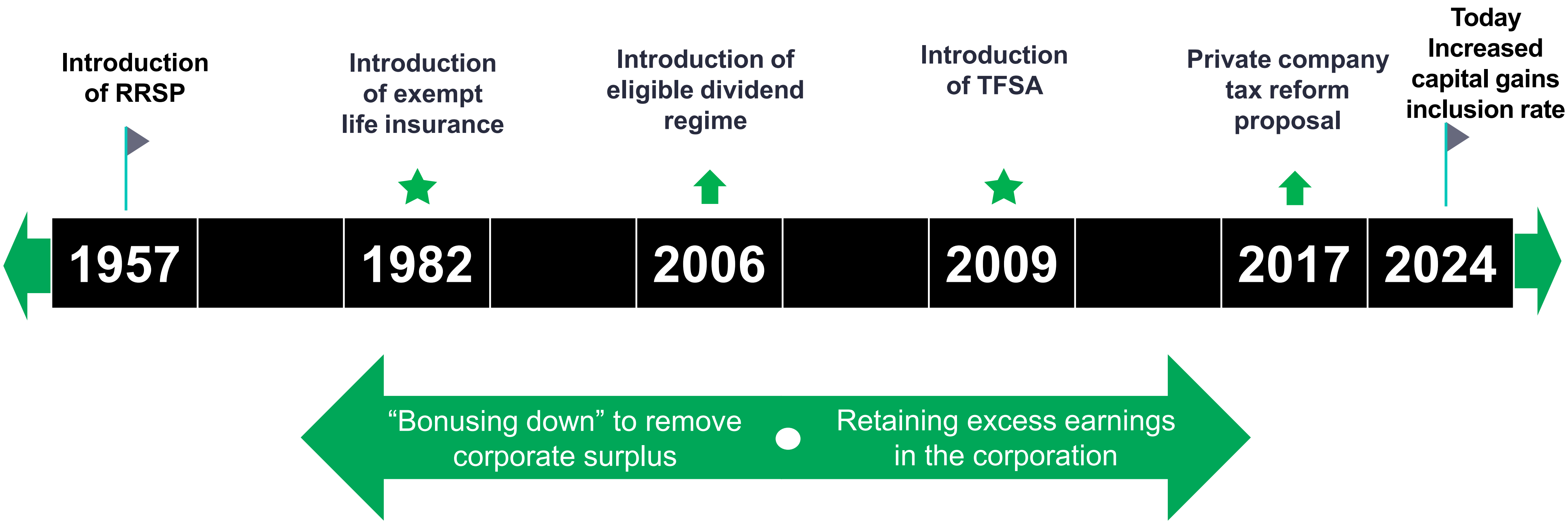
Agenda

- Trapped Surplus – How did we get here?
- Post mortem planning update
- The double tax problem and post-mortem planning…
- Corporate beneficiary designations – be careful!

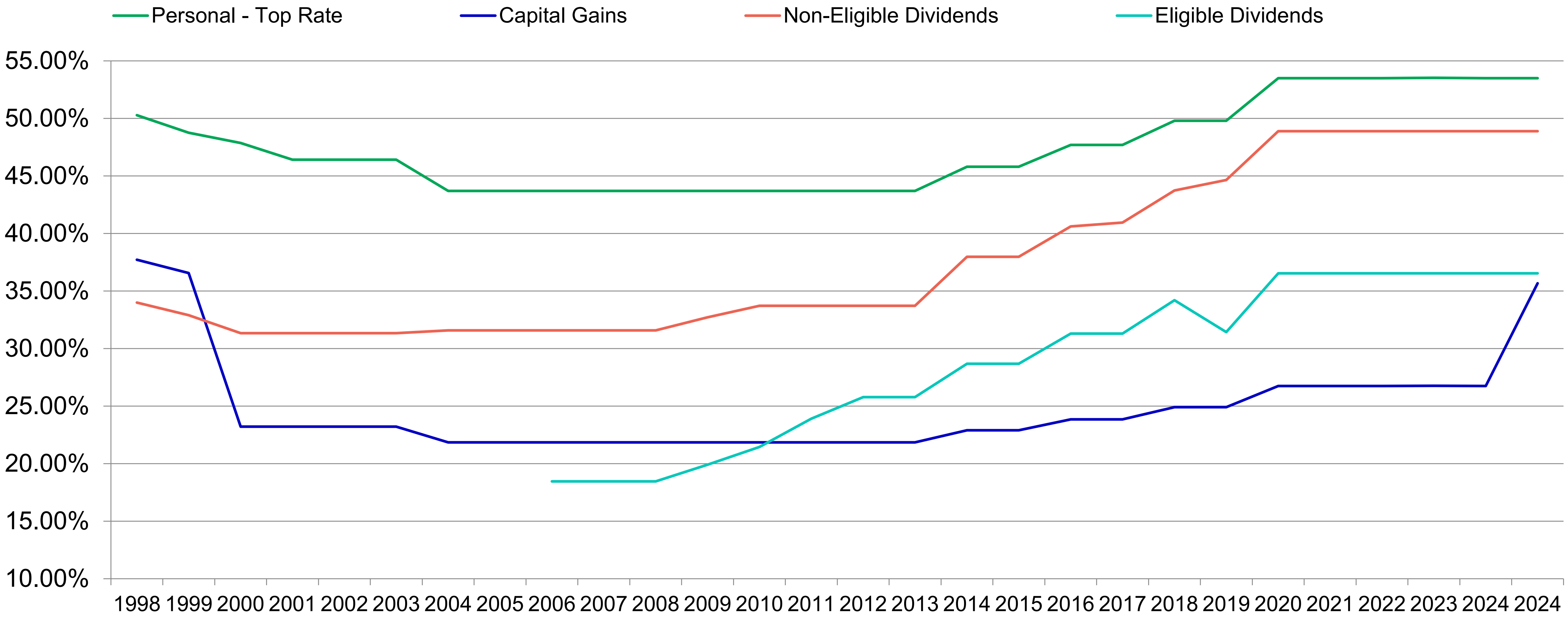
The tax deferral story



Tax measures affecting how we save



Personal tax rates – the last 25+ years (BC)



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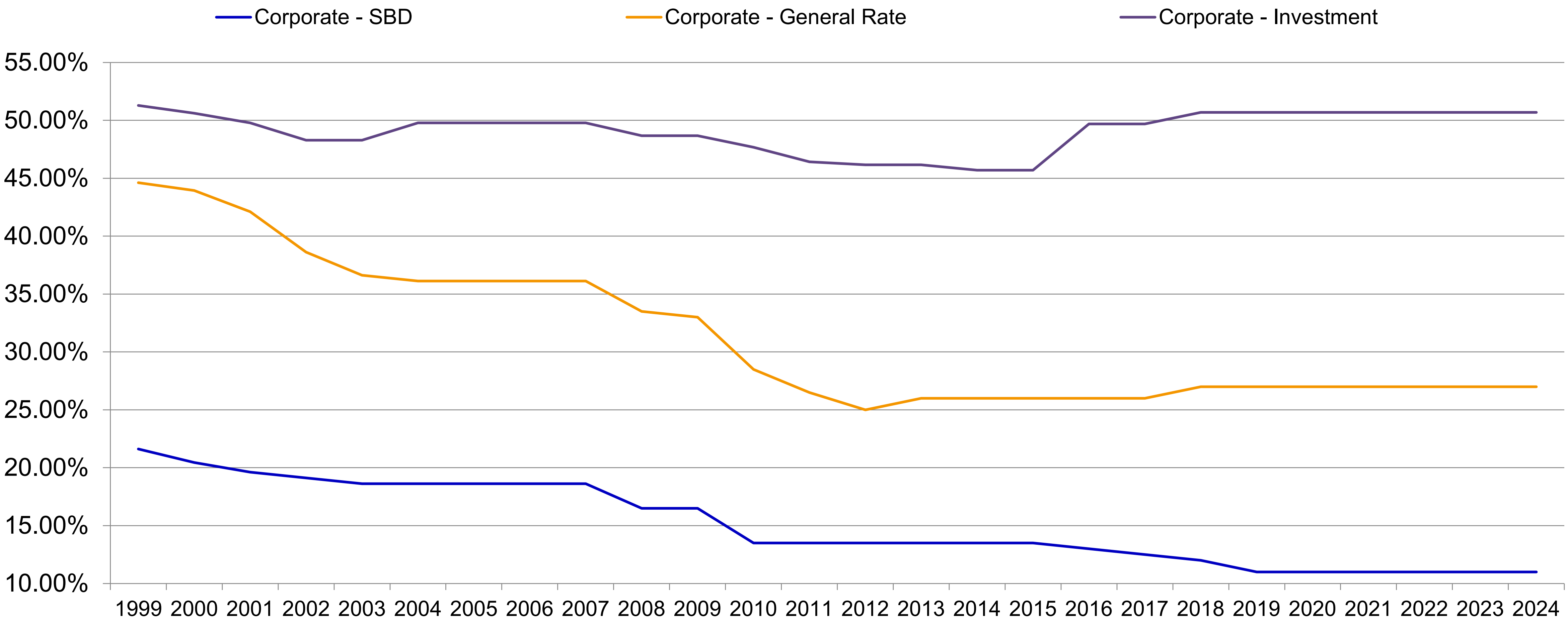
* BC tax rates used for illustration purposes

Corporate tax rates – the last 25+ years (BC)



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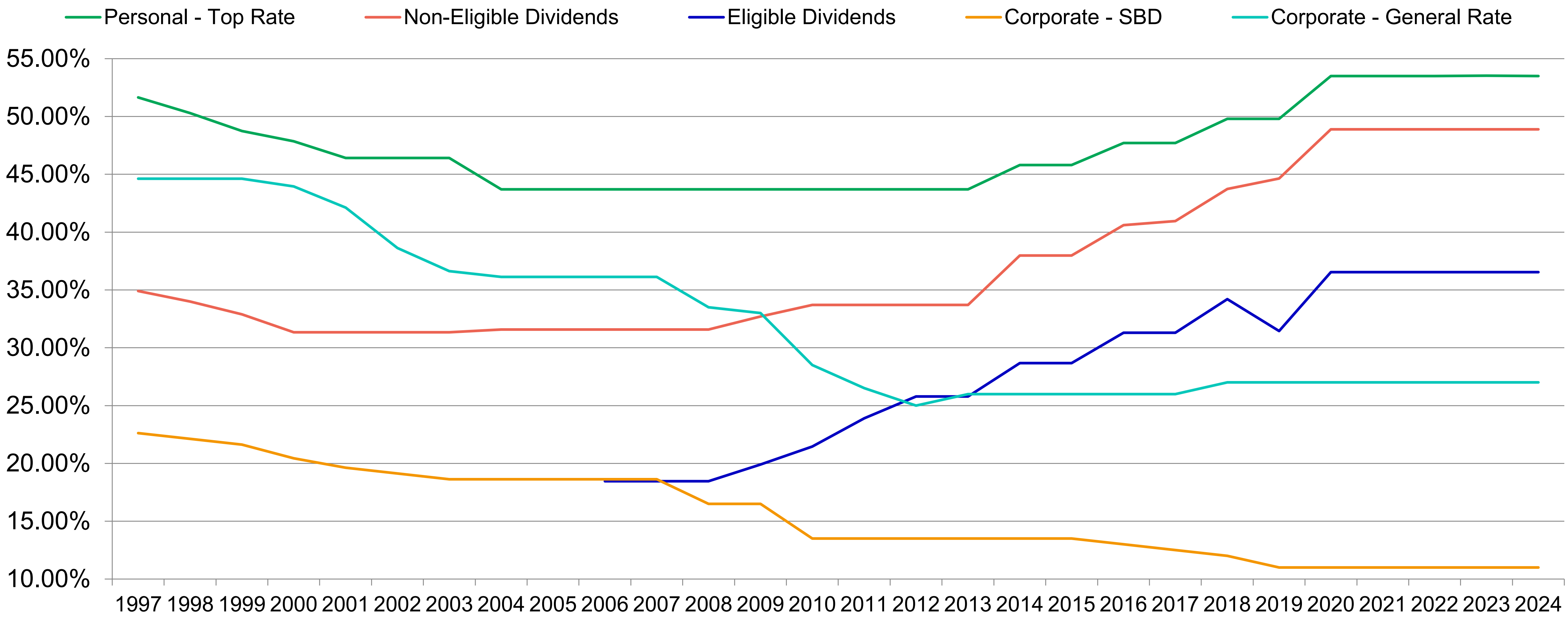
Personal tax rates increasing, corporate tax rates decreasing (BC)



* BC tax rates used for illustration purposes

Summary

- Eligible/Non-eligible dividend regime
  - Better integration = more deferral
- Falling small business rates = more deferral
  - Lower corporate tax rates = higher personal rates on dividends
  - Integration discrepancies arise on a year over year basis
- TOSI makes it more challenging to split income
  - More incentive to defer through a corporation
- Small business deduction clawback = less future deferral

Double taxation, post mortem planning and what's changing

Post mortem Planning

Purpose:	Techniques:	Current state of pipeline planning:
• Minimize overall tax burden associated with death and beneficiary distributions • Reduce or eliminate double taxation of corporate owned assets	• Redemption and loss carryback planning - Subsection 164(6) • Pipeline planning • Paragraph 88(1)(d) bump • Hybrid planning – combination of the above	• Lots of rulings

What’s changing?

- Capital gains inclusion rates
- Redemption and loss carryback for Graduated Rate Estates (GRE’s)
  - 164(6) loss carryback period
  - 112(3.2) stop loss rules
- Pipelines and non-residents
  - 212.1(6)(b)
  - Positive pipeline rulings

Capital gains inclusion rate increases

- Increase to 2/3 inclusion rate for all capital gains
- Exclusion for individuals, GRE’s and QDT’s
  - First $250K of capital gains ½ inclusion rate, 2/3 thereafter
- Will have an impact on all post mortem planning

Redemption and loss carryback

- August 12, 2024 technical tax bill (“TTB”)
- Extension of time limit for capital losses realized by the GRE to be carried back to the terminal tax return of the deceased from one taxation year to three taxation years
  - Increased flexibility, better alignment, accommodates more complex estate administration
  - Also see STEP Canada Submission relating to Subsection 164(6), Misaligned Timing, and the Avoidance of Double Taxation dated June 21, 2024
    - Manulife involved with submission

Stop-loss rules 112(3.2)

- August 12, 2024 TTB
- Two macro changes:
  - Updating the rule to reflect a 2/3 inclusion rate
    - Stop-loss reduction will be equal to 1/3 of the lesser of the capital loss realized by the GRE, or the capital gain realized from the disposition of shares because of an individual's death
    - Previously it was 1/2
  - Applicable for any capital loss realized by the GRE in its first 3 years
    - Previously 1 year

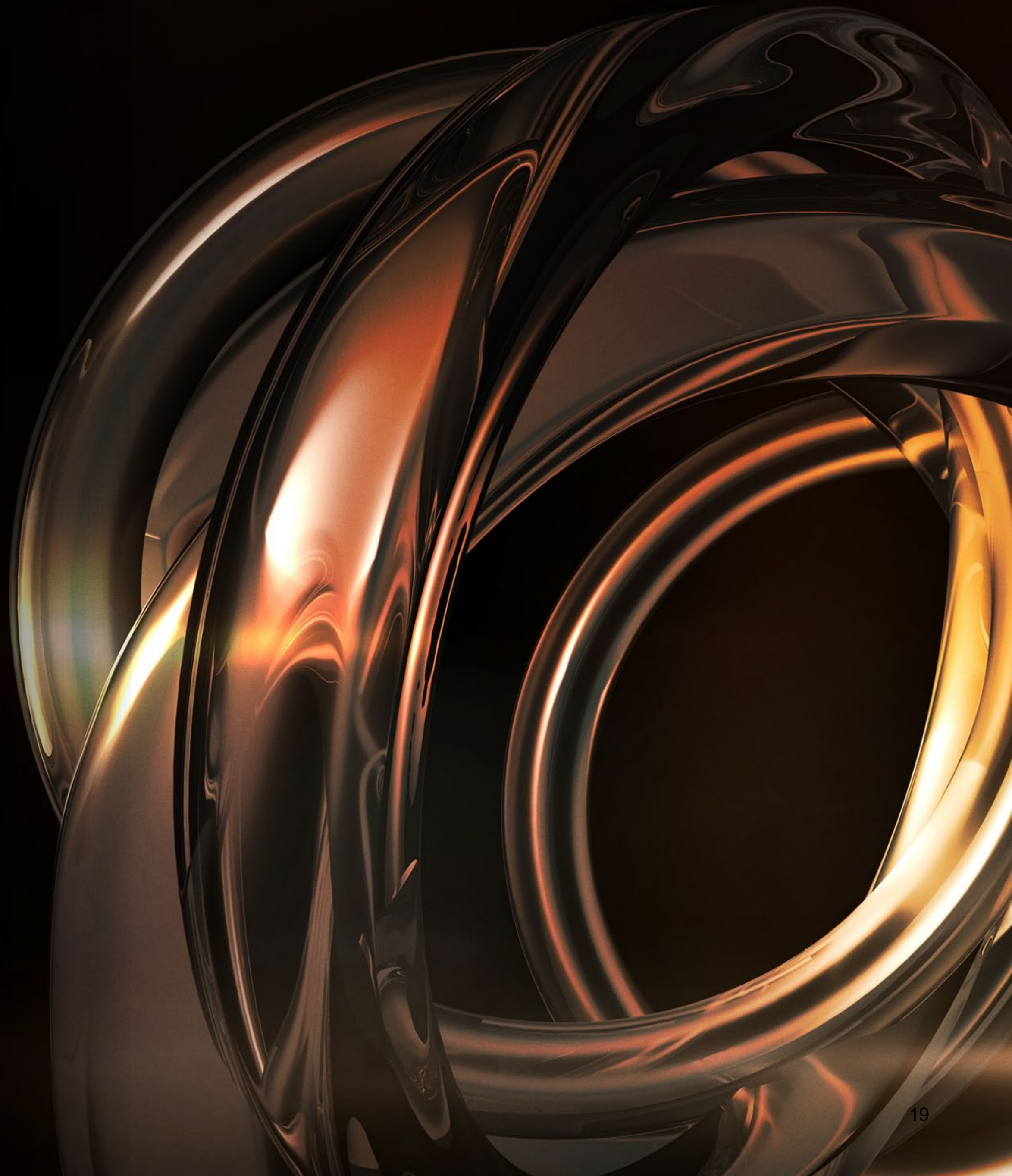
Pipeline and Non-Residents: 212.1(6)(b)

- 212.1(6) anti-avoidance first introduced in 2018 with a look-through rule for partnerships and trusts
  - Concern from tax community with the drafting such that it negatively impacted GRE's engaging in pipelines with non-resident beneficiaries and double taxation
  - Finance Canada issued a comfort letter indicating they would recommend a change to 212.1(6)(b) to exclude GRE's.
- TTB has now addressed this issue
  - Excludes the application of the look-through rules on the disposition of shares by a non-resident trust or by a trust resident in Canada that is a GRE.
  - The trust must have acquired the shares as a consequence of the individuals' death and the individual must have been resident of Canada immediately before death
  - Change effective for dispositions taking place after February 26, 2018
  - Life interest trusts not covered by this rule

Pipeline and Positive Rulings

- 2023-0987941I7 dated March 6, 2024
- The CRA indicated that they will continue to issue favourable Rulings on the non-application of new GAAR in the context of post-mortem pipeline transactions.
- “The Directorate does not consider the use of a pipeline transaction as a means to preserve the capital gain arising on the death of a shareholder while limiting double taxation on the subsequent distribution of Opco's assets to be a misuse described in paragraph 245(4)(a) or an abuse within the meaning of paragraph 245(4)(b). Accordingly, the Directorate will continue to issue favourable Rulings on the non-application of the amended GAAR in the context of post-mortem pipeline transactions that meet our existing administrative guidelines described in document 2018-0748381C6.”
- The CRA has kept the door open for post mortem planning using pipeline transactions.
- The CRA also indicated that it will not provide Rulings for inter vivos pipeline transactions.

Numerical Example – Preferred Shares



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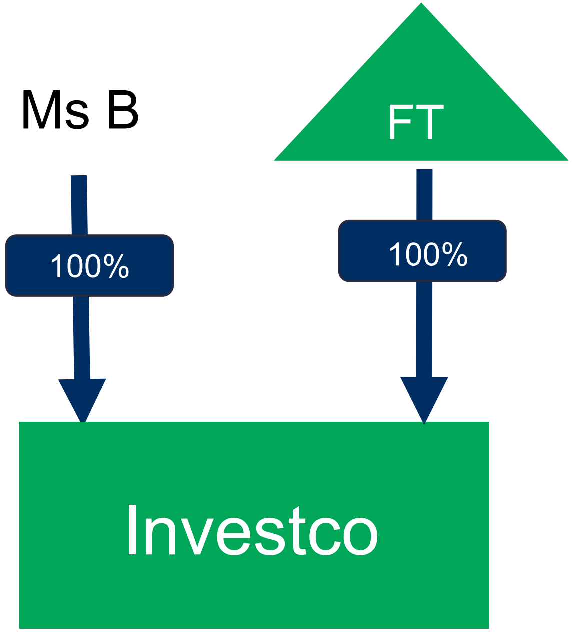
Example 1: Post mortem planning – Preferred Shares



Preferred Shares

FMV = $1M

ACB/PUC = Nominal

- Scenario 1 – No insurance
- Scenario 2 – Life Insurance/CDA =$1M

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• INTERNAL

Assumptions…

- Tax rates
  - Non-eligible dividends 48.89%
  - Eligible Dividends 36.54%
  - Interest & other income 53.50%
  - Capital gains 35.67%
  - Corporate tax rate 50.70%

Post mortem planning – Before June 25, 2024

	No Planning	Redemption with Loss Carryback			Pipeline	
		Alternative Investment	Life Insurance – Stop Loss	Life Insurance – 50% Solution	Alternative Investment	Life Insurance
Pre-tax distribution available	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Less: Tax on capital gains	(267,500)	-	($133,750)	-	(267,500)	(267,500)
Less: Tax on dividends	(488,900)	(488,900)	-	(244,450)	-	-
Net funds to estate	243,600	511,100	866,250	755,550	732,500	732,500
Effective tax rate	75.64%	48.89%	13.38%	24.45%	26.75%	26.75%
CDA Remaining				$500,000		$1,000,000

Post mortem planning – After June 25, 2024

	No Planning	Redemption with Loss Carryback			Pipeline	
		Alternative Investment	Life Insurance –Stop Loss	Life Insurance – 33.33% Solution	Alternative Investment	Life Insurance
Pre-tax distribution available	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Less: Tax on capital gains	(356,667)	-	($237,778)	-	(356,667)	(356,667)
Less: Tax on dividends	(488,900)	(488,900)	0	(325,933)	-	-
Net funds to estate	154,433	511,100	762,222	674,067	643,333	643,333
Effective tax rate	84.56%	48.89%	23.79%	32.59%	35.67%	35.67%
CDA Remaining				$666,667		$1,000,000
Decrease in NEV compared to 50% inclusion rate	(89,167)	0	(104,028)	(81,483)	(89,167)	(89,167)

Numerical Example – Common Shares

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Example 2: Investment Company

Mr. A (55)

100%

Investco

Proceeds from Sale of Business

29 years

- $1,000,000 invested immediately
- Portfolio
  - 40% Interest @ 3%
  - 20% Dividends @ 3%
  - 20% Realized CG @ 6%
  - 20% Deferred CG @ 6%

Mr. A (immediately before death)

100%

FMV = $6.7 M

ACB = $0

PUC= $0

Investco

Investment Portfolio

FMV = $5.7 M

ACB = $4.8 M

RDTOH = $1.0M

CDA = $211K

Includes Other assets of $3.1 M portfolio with $3.1 M ACB at LE and $662K of RDTOH

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Numerical Example – Common shares Comparison

$2,000,000

- Invested in GIC at 3% over 29 years
- At life expectancy, value equals approximately $3,062,000
- RDTOH $660,479

+

$1,000,000 into Life Insurance

- Death benefit $3,438,562
- CSV $2,558,859
- ACB $ nil
- CDA $3,438,562

or

$1,000,000 into Alternative Investment (pre-tax values)

- FMV $2,655,567
- ACB $1,771,890
- RDTOH $348,722
- GRIP balance $227,565
- CDA $210,956

Assumptions…

- Tax rates
  - Non-eligible dividends 48.89%
  - Eligible Dividends 36.54%
  - Interest & other income 53.50%
  - Capital gains 35.67%
  - Corporate tax rate 50.67%
- Value of company based on value of underlying assets, not adjusted for deferred income taxes.

Post-mortem Planning — Common Shares

	No Planning
Pre-tax distribution available	6,608,944
Less: Tax on capital gains	(2,376,922)
Less: Tax on dividends	(2,955,862)
Net funds to estate	1,276,160
Effective tax rate	80.69%

Post-mortem Planning — Common Shares

	No Planning	Redemption with Loss Carryback	
		Alternative Investment	Life Insurance
Pre-tax distribution available	6,608,944	6,608,944	7,161,041
Less: Tax on capital gains	(2,376,922)	-	(165,878)
Less: Tax on dividends	(2,955,862)	(2,955,862)	(1,791,816)
Net funds to estate	1,276,160	3,653,082	5,203,347
Effective tax rate	80.69%	44.73%	27.34%

Post-mortem Planning — Common Shares

	No Planning	Redemption with Loss Carryback		Pipeline (No Bump)	
		Alternative Investment	Life Insurance	Alternative Investment	Life Insurance
Pre-tax distribution available	6,608,944	6,608,944	7,161,041	5,419,061	6,500,562
Less: Tax on capital gains	(2,376,922)	-	(165,878)	(2,016,974)	(1,988,481)
Less: Tax on dividends	(2,955,862)	(2,955,862)	(1,791,816)	-	-
Net funds to estate	1,276,160	3,653,082	5,203,347	3,402,087	4,518,081
Effective tax rate	80.69%	44.73%	27.34%	37.22%	30.50%
CDA Remaining	-	-	-	210,956	2,558,859

Post-mortem Planning — Common Shares

	No Planning	Redemption with Loss Carryback		Pipeline (No Bump)		Hybrid: Redeem for RDTOH/CDA, Pipeline Remainder	
		Alternative Investment	Life Insurance	Alternative Investment	Life Insurance	Alternative Investment	Life Insurance
Pre-tax distribution available	6,608,944	6,608,944	7,161,041	5,419,061	6,500,562	6,608,944	7,161,041
Less: Tax on capital gains	(2,376,922)	-	(165,878)	(2,016,974)	(1,988,481)	(1,047,393)	(1,291,344)
Less: Tax on dividends	(2,955,862)	(2,955,862)	(1,791,816)	-	-	(1,489,595)	(831,293)
Net funds to estate	1,276,160	3,653,082	5,203,347	3,402,087	4,518,081	4,071,957	5,038,404
Effective tax rate	80.69%	44.73%	27.34%	37.22%	30.50%	38.39%	29.64%
CDA Remaining	-	-	-	210,956	2,558,859	-	-

Rules of Thumb

Redemption and loss carryback

- Dividend tax treatment
- Use if have CDA, GRIP or RDTOH
- Time sensitive, must be done in first year of estate
  - Amendment to extend to 3 taxation years
    - STEP made the submission!
  - Estate must be a graduated rate estate (GRE)
- Redemption and loss carryback has to consider the stop-loss rules in 112(3.2).
  - Stop loss now minimized with the “1/3 solution”
    - This is a change from the “50% solution”
      - Results in higher effective tax rates when compared to a 50% inclusion rate
- Need to consider
  - Negative CDA from earlier years
  - US persons

Rules of Thumb (continued)

Pipeline

- Beneficiaries can access corporate assets using high ACB of the shares as basis
- Use if capital gains tax rates are lower than dividend tax rates
- More complicated to accomplish than redemption and loss carryback
- Takes a number of years to distribute assets due to CRA technical interpretations
- Bump rules in paragraph 88(1)(d) are complex

Hybrid Planning

- Combines redemption of shares with pipeline
- Used to extract RDTOH and/or CDA that might otherwise get left behind

What can we do today?

- Ensure the will has sufficient flexibility
- Ensure that we have an informed executor
- Consider integrating life insurance to complement this planning

Corporate beneficiary designations – be careful!

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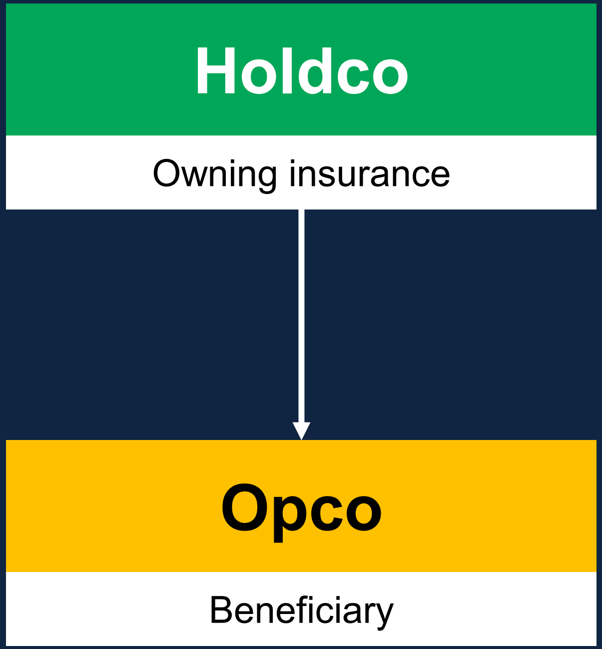
Holdco Owner Opco Beneficiary

2022 APFF CRA Roundtable Q 2

- Benefit conferral not ruled out

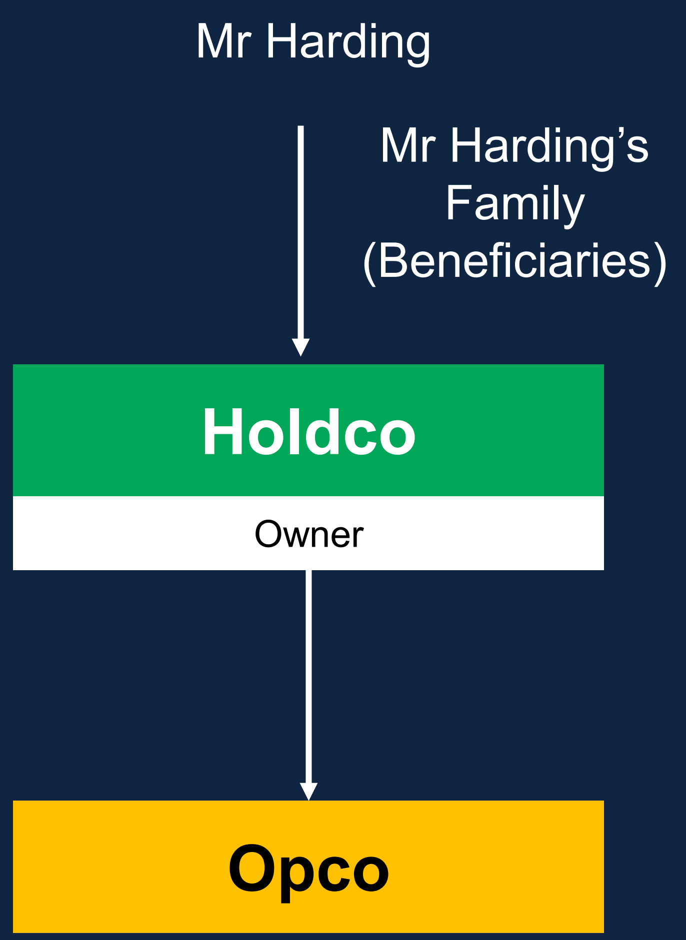
Where does this leave us – Options include

- Opco owner and beneficiary no benefit conferral but available to creditors, may need to transfer (taxable) if sale of business
- Separate joint Holdco early in the planning – additional compliance and costs, case specific, still may need to transfer later
- Holdco owner Opco beneficiary with reimbursement from Opco taxable to Holdco
- Holdco owner Opco beneficiary take risk of 246(1)



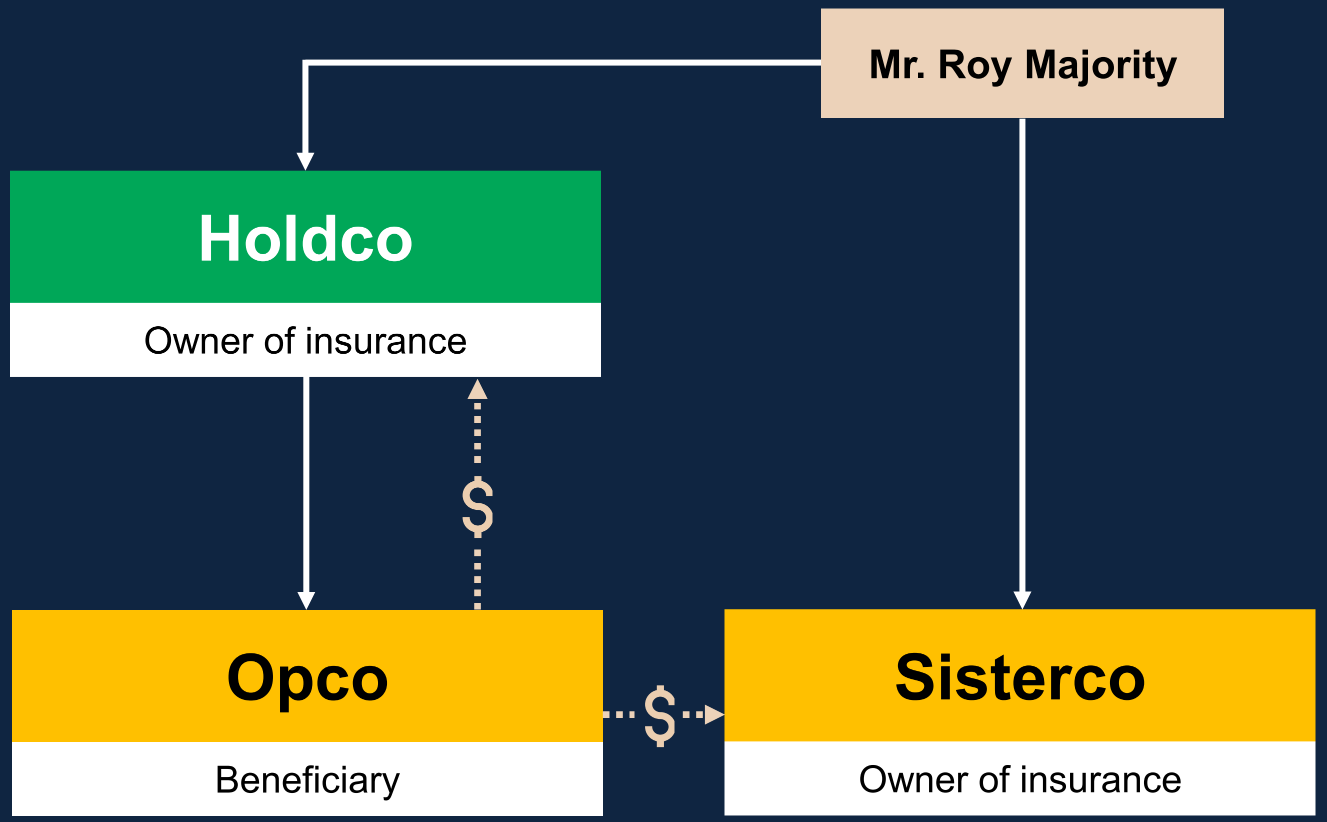
Harding v The Queen (2022 TCC 3)

- There were three insurance policies involved in this case:
  - A policy on Ms. Harding's life under which Holdco was owner and 25% beneficiary, with the children being beneficiaries of the remaining death benefit
  - Two policies on the life of Mr. Harding owned by Holdco and naming Ms Harding as the main beneficiary
- Opco paid all of the insurance premiums under the above policies, which was approximately $476,000 in 2013, 2014 and 2015
- The CRA assessed Mr. Harding for a shareholder benefit in respect of the premiums paid)



Gestion M-A Roy Inc and 4452712 Canada Inc. v. The King

- Premiums paid by Opco were included in Holdco and Sisterco’s income as shareholder and indirect benefits
- Main take away – Upstream vs. downstream big difference
- Case was recently appealed and dismissed



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What does this all mean?

- The optimal approach is consolidating owner/beneficiary/payor
  - This should minimize any benefit issues
- Second prize is having the same corporation be the owner/payor with the beneficiary being downstream.
  - In order to get cash from a subsidiary corporation to a parent corporation, consider paying an intercorporate dividend (subject to 55(2)) to the parent corporation.
  - Where the beneficiary is a subsidiary corporation, consideration should be given to 246(1)
  - Where the subsidiary corporation is the owner/payor but a parent corporation/shareholder is the beneficiary – there will be shareholder benefits to consider
- Corporate owned life insurance and beneficiary designations are coming under greater scrutiny
  - Getting it right matters more than ever!

Questions?
Thank you!

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