Welch LLP

Estate Planning for Private Company Shareholders

A previous Welch LLP article discussed the specific tax implications that arise at death. We addressed fundamental tax considerations and highlighted some proactive tax planning opportunities. Estate planning for business owners involves an added level of complexity.

Estate planning in a private company context embodies unique issues and opportunities. It is imperative that business owners understand the key issues and address tax and estate planning proactively. A business owner will want to ensure that a plan is in place to minimize tax both before and after death. Further, a business owner should ensure that the estate planning will facilitate more broad succession planning objectives. A comprehensive plan will assist in minimizing tax and provide for an organized transfer of value within a family group.

Overview:

To facilitate a review of the specific estate planning issues that arise in a private company context we will use the following fact pattern:

- Mr. Brown, a widower, owns 100% of the common shares of a successful company called BrownCo. The shares have a nominal cost for tax purposes and have a fair market value of $2,850,000 at the time of his death in March 2014.
- The BrownCo shares qualify for the $800,000 lifetime capital gains exemption. Mr. Brown has not previously claimed any part of his lifetime capital gains exemption.
- The provisions of Mr. Brown's will provide that his property is to be distributed equally to his three children.

The Income Tax Act provides that Mr. Brown is deemed to dispose of his BrownCo shares immediately before death for fair market value. Because the BrownCo shares have a nominal cost, Mr. Brown's gain in connection with the deemed disposition will be $2,800,000. He may claim the $800,000 lifetime capital gains exemption to reduce his gain to $2,000,000. As a resident of Ontario, the tax to Mr. Brown on the gain will be approximately $490,000.

The following issues/potential problems may arise for Mr. Brown's estate and beneficiaries:

Liquidity:

Based on our assumed fact pattern, Mr. Brown's estate will have a tax liability of $490,000 due on April 30th, 2015. If the tax liability is not paid in full, the estate will be subject to interest compounded daily until the balance is paid. Interest paid by the estate on its tax liability would not be deductible for tax purposes. The estate may be permitted to defer the payment of its tax liability provided that an election is filed and proper security is posted with the Canada Revenue Agency. However, interest would continue to accrue on the outstanding balance.

Unless the BrownCo shares can be quickly sold, the estate will be required to fund the tax liability with other assets of Mr. Brown's estate. This may put the estate, the executor and beneficiaries in a difficult position if the estate does not hold liquid assets.

Capital Gains Exemption:

The Act provides specific criteria which determine whether or not an individual may access the capital gains exemption in connection with the disposition of shares of a Qualifying Small Business Corporation ("QSBC"). A full discussion of the QSBC criteria is beyond the scope of this article – suffice to say that there are many reasons why the $800,000 capital gains exemption may not be available at the time of

Mr. Brown's death.

In the absence of the capital gains exemption, Mr. Brown's terminal tax liability would increase to approximately $685,000. This would reduce the after-tax value of Mr. Brown's estate and may further aggravate liquidity issues.

Accessing Value:

After Mr. Brown's death, his estate will own shares that have a fair market value and cost of $2,800,000. However, this does not represent an amount that the estate can receive as a tax-free distribution from BrownCo. A dividend paid from BrownCo to the estate would be subject to tax. The estate may generally only access the share value as a tax-free receipt if there is a party that is willing to purchase the shares from the estate.

Planning Opportunities:

Proactive planning provides opportunities to minimize tax for Mr. Brown and his estate. Post mortem strategies will also assist in minimizing tax after death and accessing corporate funds.

Estate Freeze:

An estate freeze can be used to prevent the value of Mr. Brown's shares from appreciating in the future. In a traditional estate freeze, Mr. Brown would exchange his BrownCo common shares for fixed value preference shares. Mr. Brown's children or a family trust for the benefit of Mr. Brown and his children may own BrownCo's common shares. Based on proper planning a freeze may be implemented without tax. We can also permit Mr. Brown to control the corporation via his preference shares.

The following essential benefits may arise by virtue of an estate freeze:

Fixed Terminal Tax Liability:

Mr. Brown's terminal tax liability in respect of his BrownCo shares will not increase in the future. The value of Mr. Brown's preference shares will remain the same notwithstanding that BrownCo may increase in value. The additional value will belong to the common shares owned by Mr. Brown's children or a family trust.

If Mr. Brown had completed a freeze when BrownCo had a value of $1,500,000, then his terminal tax liability would not have increased subsequent to the freeze. The fact that BrownCo had a value of $2,800,000 at the time of his death in 2014 would not affect his terminal tax liability, i.e. the amount would be based on the fixed value of his preference shares. The additional value of BrownCo would be attributable to the corporation's common shares which are not owned by Mr. Brown.

Avoiding tax on $1,300,000 of value would reduce Mr. Brown's terminal tax liability by approximately $320,000. Further, establishing a fixed terminal tax liability in respect of the BrownCo shares can assist in ensuring that the estate will be in a position to fund the tax liability.

The tax benefits of a freeze are evident; however, Mr. Brown must be comfortable with the notion of passing on future BrownCo value to his children. Mr. Brown's age should be a key consideration in determining whether or not he is ready to implement an estate freeze. However, we can provide Mr. Brown with the opportunity to access future value if he so desires – in spite of the freeze. We can accomplish this by making Mr. Brown a beneficiary of a family trust which owns the BrownCo common shares. As a beneficiary of the trust, Mr. Brown may have access to the trust property. However, because he does not own the property held by the trust, this value would not factor into his terminal tax liability.

Crystallizing the Capital Gains Exemption:

As we have noted, access to the capital gains exemption involves some complexity and this may create uncertainty as to whether or not the exemption would be available at the time of Mr. Brown's death. We can mitigate this uncertainty by crystallizing Mr. Brown's capital gains exemption in connection with an estate freeze. This can be accomplished by electing to realize a gain in connection with a share exchange which would otherwise occur on a tax deferred basis.

Pursuing the example noted above, Mr. Brown could elect to dispose of his BrownCo common shares for $800,000. A capital gain of $800,000 would be realized and the capital gains exemption would be claimed to offset tax on the gain. Mr. Brown's preference shares would have a value of $1,500,000 and a cost of $800,000. At the time of death, Mr. Brown's gain would be $700,000 and it would not be necessary for BrownCo to be a QSBC at that time.

In connection with a crystallization, we can take steps to ensure that BrownCo is a QSBC. This may include steps to remove non-active assets from the corporation. Subsequent to the crystallization, the composition of BrownCo's assets would not affect Mr. Brown's access to the capital gains exemption.

Reducing the Terminal Tax Liability:

By virtue of a freeze we have created a framework whereby the tax liability in respect of Mr. Brown's BrownCo shares will not increase in the future. We can now go one step further and actually reduce the terminal tax liability over time. This is referred to as a wasting freeze.

We may decide to have Mr. Brown receive dividends from BrownCo by redeeming preference shares over time. The income received may replace employment income or regular dividends that Mr. Brown would otherwise receive. The dividend income received via the share redemptions will be taxable to Mr. Brown; however the share redemptions will also have the effect of reducing the value of the BrownCo shares that he owns.

To illustrate the preceding, assume that Mr. Brown redeems $50,000 of preference shares annually for 10 years. On an annual basis he would pay tax on the dividend income of approximately $15,000. However, the dividend income may replace employment income that Mr. Brown would otherwise receive from BrownCo, for this reason the $15,000 of annual tax may not be an incremental liability. By virtue of redeeming $500,000 worth of preference shares Mr. Brown would decrease his terminal tax liability by approximately $125,000.

Post Mortem Planning:

The preceding comments have addressed planning that Mr. Brown may implement during his lifetime. Subsequent to Mr. Brown's death, the executors of his estate will be faced with important tax planning decisions. In particular, the executor will want to minimize tax and determine how the value embodied in the BrownCo shares will be passed on to the estate's beneficiaries.

As we have noted, the fact that Mr. Brown's shares have been subject to a deemed fair market value disposition does not automatically permit the estate to extract such value from BrownCo. Pursuing our basic preference share example with the value reduced to $1,000,000 via redemptions; subsequent to Mr. Brown's death, the estate will own preference shares that have a fair market value and tax cost of $1,000,000. By virtue of the $800,000 lifetime capital gains exemption, Mr. Brown's terminal tax liability in respect of the BrownCo shares would be approximately $46,000 (tax on a $200,000 capital gain).

The Income Tax Act provides that a capital loss realized by an estate in its first taxation year may be carried back to the deceased's terminal return. In our context we may redeem the shares and realize a $1,000,000 dividend and a $1,000,000 capital loss. The capital loss could be applied against the $200,000 capital gain realized on Mr. Brown's BrownCo shares. Further, an additional $800,000 of capital losses would be available to offset other capital gains on Mr. Brown's terminal return. The estate would receive $1,000,000 in cash from BrownCo and would be left with after tax proceeds of approximately $700,000. This plan is normally referred to as a "Section 164(6)" plan – this is a reference to the Income Tax Act provision that permits the application of the loss realized by the estate to Mr. Brown's terminal return. The important downside to this plan arises by virtue to the $300,000 of tax that applies on the share redemption.

Alternatively, the executor may contemplate what is colloquially referred to as a "pipeline" strategy. In such circumstances, a new corporation is incorporated by the estate and the BrownCo shares are transferred to the new corporation. This new structure provides an opportunity for the estate to extract on a tax-free basis the tax cost embodied in the BrownCo shares. However, it is important to note that the tax cost related to the capital gains exemption may not be extracted without tax. For this reason the estate would be limited to $200,000 which can be received as a tax-free distribution. Based on our fact pattern a pipeline plan may not be an effective strategy. It may be possible, however, to combine both the "Section 164(6)" and the "pipeline" strategies to maximize the tax savings.

In the end, comparing the first result (with no planning) of a tax liability $465,000 (with the potential of further taxes to the estate on withdrawal of funds from the company) and the final result (with proper planning) of a tax liability that could be as a low as $200,000, it is clear how beneficial proper estate planning can be.

This article has addressed key estate and tax planning issues that arise in respect of private company shares. We have discussed some of the fundamental strategies that may be implemented to minimize tax for a private company shareholder and his or her estate. It is imperative that business owners proactively establish, the sooner the better, a comprehensive estate plan that is customized to meet their needs and specific objectives.

For more information about estate planning for private company shareholders contact a professional at Welch LLP or visit us at: www.welchllp.com

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