Estate Planning for Business Owners

Understanding taxation upon death of a shareholder.

As a successful business owner, you've accumulated substantial wealth and are considering selling your business. This article aims to simplify the key points of estate planning and the three levels of taxation at death.

STEP 1: SELLING YOUR BUSINESS

When selling your business, you have two main options:

1. Sale of Assets: The buyer acquires only the assets and goodwill, not the company's liabilities. This triggers a taxable dividend, with tax rates ranging from 40% to 48%, depending on the type of dividend and your province of residence.

2. Sale of Shares: Preferred by sellers as it generates a capital gain, taxed at a marginal rate of around 26%. You might also qualify for the Capital Gains Exemption (CGE) with proper planning.

After the sale, proceeds typically go into your holding company, with some amounts payable directly through the Capital Dividend Account (CDA). Most funds remain in the holding company, from which you can draw taxable dividends as needed to support your personal lifestyle.

STEP 2: RETIREMENT PLANNING

Consult a Professional Financial Planner to ensure your assets will support your retirement lifestyle. This step is crucial for peace of mind and helps optimize fund withdrawal strategies. Effective tax planning can maximize your returns and minimize taxes, stretching your money further. Different accounts like RRSPs, TFSAs, and corporate accounts are taxed differently, so strategic planning is essential.

STEP 3: ESTATE PLANNING

Once your retirement needs are secured, focus on your legacy. Without proper planning, double and triple taxation can significantly reduce the amount left to your heirs, potentially exceeding 70% in taxes.

Estate tax planning needs to be done sooner rather than later. Your Estate Executor will not be able to do much if the proper steps are not put in place at the outset. Once again, planning to optimize taxes will help ensure your family receives the bulk of your estate.

THREE LEVELS OF TAXATION UPON DEATH

1. Deemed Disposition: Upon death, all assets are considered sold at Fair Market Value, triggering a capital gain on real estate, stocks and shares of a Canadian Controlled Private Corporation (CCPC).

   For example: Your company is worth 4 million. The portfolio inside has a cost basis of 3 million. What's the tax liability for the deceased? **Most will say 1 million… Wrong answer.**

   The shares of the holding company were initially issued at $100 (very typical). So, the capital gain on the deemed disposition really is 4 million – $100 (let's round up to 4M)

   Tax payable: 4 million x 50% (taxable portion of capital gain) x tax rate of 53.31% = $1,066,173

That's Level 1 (Tax paid on disposition: $1,066,173)

2. Personal Tax Declaration: The tax amount must be paid on the deceased's personal tax return, but the funds are in the holding company. To pay the tax, a taxable dividend must be issued at a 47% tax rate. The company may be entitled to some RDTOH (an integration mechanism), but to keep things simple: to net $1,066,173, a dividend of $2,078,039 is required.

That's Level 2 (Tax paid on dividend: $ 1,012,137)

3. Generating Liquidity: The company may need to sell stock to generate liquidity, incurring a 25% tax on capital gains. For instance, selling $2 million of stock with a $1 million cost basis results in a $1 million capital gain, taxed at 25%, equating to $250,000.

That's Level 3 (Tax paid on capital gains: $250,000)

Total Tax Paid from Estate: $2,328,310
This leaves your heirs with just $1,068,004 instead of the initially planned $3 million.

MITIGATING DOUBLE TAXATION

Several post-mortem strategies can help reduce double taxation, such as the "Pipeline" strategy or Roll & Redeeming of shares. Consult your tax professionals to explore these options.

Life Insurance: A straightforward tool to alleviate double taxation. Life insurance proceeds are eligible for the CDA, making them tax-free. Premiums grow tax-deferred and are paid out tax-free, providing significant benefits.

Most wealthy Canadian business owners use life insurance not just for protection but for its tax advantages. Don't overlook this valuable tool in your estate planning.

RAYMOND JAMES®