

Stop-Loss Rules Revisited

The 50% Solution

In April 1995 new income tax rules were introduced that severely restricted some estate planning strategies involving corporate owned life insurance. These rules are commonly referred to as the "stop-loss" rules. With the proposed reductions in the taxable capital gains rate from 75% to 66 2/3% in February 2000, and then to 50% in October 2000, these stop loss rules and the planning for them should be revisited.

This issue of Blueprints will examine the stop loss rules in the context of the following scenario:

- Mr. A and Mr. B each own 50% of AB Co.
- Mr. A dies.
- Mr. A's shares have a fair market value on death of \$1,000
- Mr. A's adjusted cost base ("ACB") of the shares is nil.
- The paid up capital ("PUC") of the shares is nil.
- AB Co. has life insurance of \$1,000 on Mr. A.
- The full death benefit is added to AB Co.'s capital dividend account ("CDA").
- The shares owned by Mr. A are not "grand fathered" shares, and are therefore not exempt from the stop-loss provisions.
- Mr. A and his estate are both in the highest income tax bracket, which is assumed to be a 50% bracket.

Background

Prior to April 26, 1995 corporate owned life insurance could have been used to redeem Mr. A's shares on his death, and completely eliminate the tax that Mr. A would have to pay on the value of those shares. Initially, on Mr. A's death he would be deemed to have disposed of his shares at fair market value, and the resulting capital gain would be reported in his final income tax return. After his death, AB Co. would redeem these shares from Mr. A's estate. The redemption would result in a deemed dividend being paid, and a capital loss being realized on the disposition of the shares. Because AB Co. would have a capital dividend account from the receipt of the insurance proceeds, the deemed dividend on the redemption could be a tax-free capital dividend. The capital loss realized by Mr. A's estate on the redemption could be carried back to Mr. A's final tax return to offset the capital gain, thus eliminating tax on the disposition of the shares. The tax saved by Mr. A would essentially be deferred and paid by Mr. B on his death.

Stop Loss Rules

In April 1995 the Department of Finance introduced rules to prevent this very favourable result. Basically, these stop loss rules work such that if the deemed dividend on the redemption of the shares is a tax-free capital dividend, then the estate cannot carry back the full capital loss to the deceased's final tax return. Generally however, a loss carry-back was allowed up to 25% of the lesser of the capital gain on death and the capital loss realized in the estate.

However, the rules also worked such that if only 25% of the dividend paid on redemption was a tax-free capital dividend, then the loss carry-back would not be restricted. This became known as the "25% solution". In our scenario, Mr. A would pay no tax on the capital gain on death because of a full loss carry-back would be allowed, but his estate would pay tax on a taxable dividend of \$750. Paying tax on a \$750 dividend was preferable to paying tax on a \$750 capital gain because the effective tax rate on dividends was lower than that on capital gains. As well, if the redemption amount was fully funded by insurance, as it is in our scenario, then the corporation had a balance in its capital dividend account of \$750. This could be paid out as a tax-free capital to Mr. B as funds become available to the corporation.

50% Solution

Now with the proposed reduction in the capital gains inclusion rate to 50% for dispositions after October 17, 2000, the "25%/r solution" will become the "50% solution". That is, up to 50% of the dividend on redemption can be received as a capital dividend without restricting the loss carry back to the final tax return.

The chart at the bottom of the page summarizes the result of the redemption being paid fully from the capital dividend account (thereby triggering the restricted loss carryback). This is compared to the 50% solution, and to the result if there is no insurance in place to redeem Mr. A's shares.

As you can see from the chart below, insuring the redemption amount saves income tax over the uninsured strategy. This is because one half of the loss carry back will be allowed even if the full redemption is paid as a capital dividend. However, if the "50% solution" is used, Mr. A will actually pay more tax than if the full dividend is a tax-free capital dividend. This is because the tax on the \$500 taxable dividend received by the estate is higher than the tax on the \$500 capital gain that results from the application of the stop-loss rules.

Therefore we must consider whether using the 50% solution makes sense. The main advantage of this tax planning strategy is that it leaves 50% of the capital dividend account intact to be used by the surviving shareholders. If the corporation has the funds available to pay this out shortly after Mr. A's death, then Mr. B will enjoy the tax savings on the tax-free capital dividend. On a \$500 dividend he would save tax of approximately \$167, assuming a 50% tax bracket. This has come at a cost of approximately \$40 to Mr. A and his estate. However, if the capital dividend cannot be paid out to Mr.

B for a number of years, then the time value of money will reduce the effect of Mr. B's tax savings.

The relationship between the shareholders should also be considered. If Mr. A and Mr. B are related, then Mr. A and his heirs may be more willing to pay higher taxes now and leave some of the CDA intact for Mr. B. Alternatively, if they deal at arm's length, or if the relationship is not amicable, then Mr. A and his executors may be more interested in saving tax on Mr. A's death than leaving a benefit for Mr. B.

Another disadvantage of the 50% solution is the complexity and increased professional fees. It is noted above that if up to one-half of the dividend received by the estate is a capital dividend, then there should be no restriction on the loss carry-back. However, in practice, the dividend on redemption of shares cannot be partly a capital dividend and partly a taxable dividend. Therefore there must be steps taken to pay a separate capital dividend. This often involves a reorganization of share capital, and there will be legal and accounting fees involved.

As well, one would have to consider the tax implications of the insured redemption strategy to Mr. B, as he would have no increase in the ACB of his shares of AB Co. Therefore, he would pay more tax on the disposition of his shares on his death.

Conclusion

It is no longer clear cut whether the "50% solution" is the best strategy in a situation where the redemption of shares is fully insured. The circumstances of each case must be considered carefully, and legal and tax professionals should be consulted whenever this type of estate planning is being reviewed.

	Redemption using full CDA	50% Solution	No Insurance
Capital gain on final return	500	0	1,000
Taxable dividend in estate	0	500	-
Capital dividend in estate	1,000	500	-
Tax on capital gain	125	0	250
Tax on taxable dividend	0	167	-
CDA available	0	500	-

