Don’t let your estate fall victim to double taxation

FLAGSTAFF REGION SUCCESSION SERIES

Taxes are bad enough the first time you have to pay them. But paying them twice? That should be avoided at all costs.

And yet, too often, private company shareholders–or perhaps, more accurately, their loved ones–end up paying double tax upon the shareholder’s death. This typically happens when private company shares increase in value over the duration of ownership.

To better understand how double tax exposure arises, consider the following example:

Mrs. Davis, who recently passed away, was the original and sole owner of a business. Upon her death, her shares of the business were worth $1 million. The business itself also owned a piece of land–something Mrs. Davis purchased for $200,000 25 years ago. The present-day market value of that land is $1 million.

Under the Canadian Income Tax Act, Mrs. Davis is considered to have a “deemed disposition” of the shares of her company–in other words, she is considered to have disposed of all capital property right before her death. This means that even though there wasn’t a sale, there can be capital gains–and those capital gains are subject to tax.

Because she was the business owner and did not pay anything for her shares, Mrs. Davis has a capital gain on her final tax return of $1 million (the full value of her shares). Her tax on the capital gain is approximately 240,000.

Mrs. Davis has two children who, as the beneficiaries of her will, become the owners of her shares. At this point the shares have a value of $1 million and an adjusted cost base of $1 million–meaning there is no capital gain to be realized on the children’s shares. However, shortly after the distribution of their shares, the children decide to sell the land owned by the business. The land is worth $1 million and has a cost of $200,000. Therefore, on the sale of the land, the company realizes a capital gain of $800,000. The company pays $195,000 in taxes on this capital gain.

At this point, Mrs. Davis’s estate has paid double tax. First, it paid $240,000 of tax on her final income tax return as a result of the capital gain on the deemed disposition of her shares, and then her company paid $195,000 on the $800,000 capital gain realized on the sale of the land On the same $1 million value, the Davis family has paid $435,000 (43.5 percent) in tax when they should have paid $240,000 (24 percent).

Tax planning: The silver bullet

Various alternatives exist to help shareholders reduce their exposure to double tax. Because no two scenarios are alike, however, these alternatives must be explored ahead of time and implemented during the shareholder’s lifetime.

If you would like to adopt a tax planning strategy to protect your estate from double tax, please contact Jordyn Prior – Economic Development Coordinator at 780-384-4151 or email jprior@flagstaff.ab.ca.

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