

# **CALU Report November 2007**

**OCTOBER 26, 2007**

## **Changes to Dividend Taxation**

### **Coming to GRIPs with the Impacts on Life Insurance Planning**

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## Introduction

On Nov. 23, 2005, then Minister of Finance Ralph Goodale announced measures that would reduce personal income taxes on dividends.<sup>[1]</sup> The stated intention of these measures was to help level the playing field between corporations and income trusts. These proposals were reintroduced by now Minister of Finance Jim Flaherty as part of the 2006 Federal Budget on May 2, 2006.<sup>[2]</sup> Draft legislation was released on June 29, 2006, by the Department of Finance<sup>[3]</sup> to implement the 2006 federal budget proposals aimed at reducing tax on “eligible dividends” paid after 2005. The final legislation was eventually tabled in the fall of 2006 and is now law.<sup>[4]</sup>

This paper will summarize the new dividend tax rules, in particular as they apply to Canadian controlled private corporations (CCPCs). It will explore the impact these rules have on corporate tax planning in general, and will take an in-depth look at the impact these rules will have on planning involving life insurance held by such corporations.

## Overview of the Rules

### Intended Results

The rules implement a new system for the taxation of “eligible dividends”. The effect of the new regime is that taxation of dividends received at the top federal personal rate will be reduced by about 5%.<sup>[5]</sup> This reduction is brought about by a combination of increasing the federal dividend gross-up<sup>[6]</sup> and dividend tax credit<sup>[7]</sup>. The overall intention is to correct the imbalance between the taxation of income trust distributions as compared to income earned through a corporation that is subject to both corporate and personal tax, especially where corporate earnings were taxed at the high general corporate tax rate. The federal government’s targeted top combined federal/provincial rate on dividends is approximately 20% by 2010.

The full implementation of the intended results will rely upon the provinces also implementing similar measures. The chart below indicates the extent to which the provinces have bought into the new regime:

2007	Ineligible Dividends	Eligible Dividends
British Columbia	31.58%	18.47%
Alberta	25.21%	17.45%*
Saskatchewan	30.83%	20.35%
Manitoba	36.75%	23.83%
Ontario	31.34%	24.64%**
Quebec	36.35%	29.69%
New Brunswick	35.40%	23.18%
Nova Scotia	33.06%	28.35%
Prince Edward Island	33.61%	24.44%
Newfoundland & Labrador	33.96%***	28.83%***

Definitely not with the program

\*14.55% by 2009

\*\*22.36% by 2010

\*\*\* As of July 1, 2007

With a few exceptions (noted in orange), the provinces have implemented provincial income tax changes which bring the combined rate of tax on eligible dividends down to or within a few percentage points of the expectations set by the Federal government. In discussing planning alternatives and in particular, impacts on corporate insurance planning, this paper will use the rates proposed to be in effect Ontario in 2010 as the base case. This will actually present a less favourable picture than those provinces which have more than fully adopted the Federal position but will be in the middle between those provinces that have and have not done this.

## Basics of the Federal Regime

The reduction in tax applies only to “eligible dividends”.<sup>[8]</sup> Eligible dividends in relation to CCPCs include dividends paid after 2005 from active business income that is not eligible for the federal small business deduction (including post-2000 full rate taxable income) and eligible dividends received.

### *Getting a “GRIP”*

The regime creates two new pools to enable corporations to determine their ability to pay eligible dividends. For public companies and non-CCPC private corporations, the corporation must determine its “low rate income pool” (LRIP).<sup>[9]</sup> It has to pay non-eligible dividends to the extent it has an LRIP before it can pay eligible dividends.

On the other hand, for CCPCs the legislation requires it to determine its “general rate income pool” (GRIP).<sup>[10]</sup> A CCPC can distribute eligible dividends to the extent it has a positive balance in its GRIP at the end of the taxation year in which the dividend is paid. Unlike public companies, a CCPC can pay eligible dividends first, depleting its GRIP before paying non-eligible dividends.

For a particular year, the main components of the GRIP calculation at the end of the year can be summarized as follows:

- GRIP at the end of the previous year,
- Less eligible dividends paid in the previous year,
- Plus 68% x taxable income (less any losses arising in the year that are carried back to prior years) for the year that did not benefit from the small business deduction and excluding investment income (other than eligible dividends);
- Plus eligible dividends or dividends paid by a foreign affiliate of the CCPC received in the year.

The GRIP balance at the end of any particular year tries to approximate the corporation’s undistributed after-tax earnings that were subject to the high general federal corporate tax rate. The opening GRIP balance for 2006 tries to approximate this amount for the corporation’s 2001-2005 taxation years.<sup>[11]</sup>

There are also adjustments to the GRIP or LRIP which must be calculated on a non-CCPC becoming a CCPC or CCPC becoming a non-CCPC.<sup>[12]</sup>

It is clear that given the complexity of these rules, CCPCs will require specialized tax advice to determine the amount of a corporation’s GRIP.

The rules also provide for the ability of a CCPC to elect to be treated as a non-CCPC.<sup>[13]</sup> If such an election is made, GRIP would not have to be calculated, but rather the CCPC will have to determine its LRIP. Also, once this election is made the corporation would no longer be entitled to the small business deduction. The non-CCPC is permitted to pay all dividends out as eligible dividends except to the extent of any LRIP. The calculation of the LRIP is complex but is intended to capture tax paid earnings of the company that either benefit from preferential rates of tax (like the small business rate) or which applied because of the receipt of taxable dividends other than eligible dividends from Canadian corporations.

### ***Designating a dividend as an eligible dividend***

Payment of eligible dividends can be made any time during the year so long as they are designated as eligible dividends. This means that so long as the GRIP at the end of the year allows for the dividend to have been paid, it can be paid during the year prior to the year-end calculation. To designate an eligible dividend, the corporation must provide the recipient with written notice at the time the dividend is paid that the dividend is an eligible dividend. There are no provisions which allow for late, amended or revoked designations <sup>[14]</sup> except as noted below. Therefore, recipients of dividends designated as eligible dividends can generally rely on the designation in determining the tax implications to them of receiving the dividend.

Despite the personal tax savings resulting from these proposals, there are some downsides for recipients of eligible dividend income. Because one of the mechanisms by which lower taxes are delivered is through increasing the gross-up, this increases net income and can impact benefits like Old Age Security, Child Tax Benefit and GST Credit which are income-tested. Also, alternative minimum tax (AMT) calculations have not been adjusted to account for lower taxation on eligible dividends. This may result in AMT applying in respect of eligible dividends received by individuals.

If a dividend is designated as an eligible dividend and the GRIP at the end of the year is less than the eligible dividends designated to have been paid, the corporation will be subject to a penalty tax <sup>[15]</sup> equal to 20% of the excessive dividend designation. This tax is increased to a penalty of 30% on the entire dividend if the excessive dividend designation results from an avoidance transaction. Non-arm's-length shareholders of a CCPC are jointly and severally liable for penalty tax arising from excessive designations.<sup>[16]</sup>

All Canadian resident corporations that pay taxable dividends (eligible or non-eligible) are required to file a return estimating the corporation's liability for this penalty tax.<sup>[17]</sup>

If an excess designation was inadvertent, the corporation can undo the excess designation after the fact by filing an election (within 90 days of the notice of assessment relating to the penalty tax) to treat all or a part of the excess designation as a non-eligible dividend.<sup>[18]</sup> Does this require consent of all recipient shareholders?

## General Impacts on CCPCs and Their Shareholders

### Preference for Eligible Dividends over Capital Gains

One of the implications of the dividend tax measures is that in most provinces, the rate of tax on eligible dividends will now be lower than or very close to capital gains. As a result, in general, the order of preference in most provinces will be to receive eligible dividends first, capital gains second, then ineligible dividends.[\[19\]](#)

The following chart compares eligible dividends to capital gains received by taxpayers at the highest marginal rate by province for 2010:

<b>2010</b>	<b>Eligible Dividends</b>	<b>Capital Gains</b>	<b>Difference</b>
<b>British Columbia</b>	18.47%	21.85%	-3.38%
<b>Alberta</b>	14.55%	19.50%	-4.95%
<b>Saskatchewan</b>	20.35%	22.00%	-1.65%
<b>Manitoba</b>	23.83%	23.20%	0.63%
<b>Ontario</b>	22.36%	23.21%	-0.85%
<b>Quebec</b>	29.69%	24.11%	5.58%
<b>New Brunswick</b>	23.18%	23.48%	-0.29%
<b>Nova Scotia</b>	28.35%	24.13%	4.23%
<b>Prince Edward Island</b>	24.44%	23.69%	0.76%
<b>Newfoundland &amp; Labrador</b>	28.83%	22.75%	6.08%

### Annual Considerations

CCPCs with a positive GRIP will be inclined to distribute eligible dividends to trigger dividend refunds to the extent that the corporation has refundable dividend tax on hand.[\[20\]](#) Depending on the corporation's sources of income this may be an annual consideration. It is interesting to note that the availability of refundable dividend tax on hand can switch the preferred order of receipt even for ineligible dividends.[\[21\]](#)

## Bonusing Down: A New World Order

Prior to the new dividend regime, the conventional wisdom for CCPCs earning active business income was to pay a bonus to the owner-manager to ensure the business' taxable income for a given year did not exceed the amount eligible for the small business deduction. The owner-manager would then lend the after-tax funds back to the corporation to the extent the funds are needed by the business. For example, assume a private corporation has \$1 million of active business earnings in excess of the small business limit [\[22\]](#):

Bonus received	\$1,000,000
Less personal income tax @ 46%	<u>(\$ 460,000)</u>
Net cash loan to Opco	<u>\$ 540,000</u>

Cash flow to Opco <a href="#">[23]</a>	
Loan from shareholder	\$ 540,000

The new dividend rules change the equation. Retention of \$1,000,000 of small business earnings would yield an immediate tax savings, allowing higher cash flow to Opco as follows:

Corporate high rate earnings	\$1,000,000
Less Corporate income tax @ 36%*	<u>(\$ 360,000)</u>
After tax cash in Opco	<u>\$ 640,000</u>

\*Federal income tax rate reduction proposals would bring this tax rate down to 32.5% after 2011[\[24\]](#), leaving even more after-tax cash at the corporate level in coming years.

This would also generate a positive general rate income pool (GRIP) balance in this example of \$680,000[\[25\]](#).

Corporations will consider retaining corporate earnings (and thus building up their GRIP account) to benefit from the upfront tax deferral, particularly where it is anticipated that the ultimate payment of a dividend will occur further out in time. If the income is retained at the corporate level for a long enough period of time, the accumulated benefit of the tax deferral will more than offset any additional tax cost that arises when the income is ultimately paid out to the owner-manager as a taxable dividend.[\[26\]](#) The additional cash available to the corporation if it retains the earnings may be reinvested in the business which may more than pay for any ultimate tax cost on the payment of a dividend.

## Impacts on Planning Involving Corporate Owned Life Insurance

### Larger Corporate Retentions for Active Business – Larger Capital Gains

The propensity to leave earnings at the corporate level to be taxed at the general corporate rate rather than bonusing down will leave more capital at work in the business. This could result in the business growing in value and may result in higher share values for purposes of the deemed disposition of a deceased shareholder's shares on death.[\[27\]](#) Life insurance funding for tax liabilities arising from the deemed disposition of a deceased shareholder's shares may be held personally or by the corporation.

Some commentators suggest that the higher corporate retentions which would also be accompanied by higher GRIP account balances may not bring about higher ultimate capital gains. This is due to the fact that there may be more impetus to do estate freezes combined with redemptions during the shareholder's lifetime which utilize eligible dividends to "waste away" the frozen shares and with it, capital gains tax liability that would otherwise arise on death.[\[28\]](#)

It is worth noting that corporate life insurance strategies which target producing cash flows (such as corporate insured annuities or leveraged corporate life insurance) could be used to provide the funding for serial redemptions using eligible dividends. Such insurance strategies can cover ultimate liabilities which may remain, while at the same time providing the funding for a wasting freeze scenario.

### Larger Corporate Retentions – Corporate Investment Planning

Where corporate retentions end up being invested in passive investment assets, the role of corporate-owned life insurance can be to serve as a tax-sheltered investment vehicle during the life of a shareholder with the ability on death to distribute the death benefit (including cash values arising from invested corporate surplus) via the capital dividend account.[\[29\]](#)

Some focus is placed on the fact that the cash surrender value of a corporate-owned life insurance policy would be a passive investment asset of the corporation and could put the corporation "offside" of the asset tests for purposes of qualifying for the capital gains exemption [\[30\]](#). However, if the corporation did not accumulate capital in life insurance, it would be some other non-qualifying asset, so the corporation should be indifferent to the investment in life insurance in these circumstances. Where this is the case, a GRIP balance improves both the insurance and non-insurance passive investment scenario as any taxable dividends distributed would be received by the shareholder at eligible dividend tax rates. In the insurance investment scenario, the results are supplemented by capital dividends produced by the insurance.

## Corporate Retention and Retirement Compensation Arrangement Planning

Retirement Compensation Arrangement (RCA) strategies are often compared to the traditional bonus-down and loan back strategy for owner-managers. Will RCAs still be a viable alternative when considering the new world order where companies are more likely to retain funds at the corporate level, pay the general corporate tax rate and thus create a GRIP balance? Options for supplemental retirement income planning for owner-managers should take into account and contemplate the use of the company's GRIP balances in the future.

In considering the alternative approaches to providing retirement income supplements to an owner-manager, one may contrast an insurance-funded RCA to a shareholder/employee using after-tax dollars to fund a policy to provide additional funds in retirement (personal leveraged life insurance) as well as using corporate after-tax dollars to do so (corporate leveraged life insurance to pay dividends – and better yet, eligible dividends).

To compare these alternatives, the various tax rates would impact funding into each strategy. For the RCA the tax cost is the refundable tax of 50%, for the personal leveraged insurance strategy, 46% and for the corporate leveraged insurance strategy, 36%. This makes a significant difference which shows up in terms of the amount of after-tax annual income that can be derived and estate values remaining from each strategy. In comparing the after-tax income one must look at the personal tax rate of the recipient on RCA payments as these payments are fully taxable vs. tax-free loan amounts in the personal leveraged insurance strategy vs. eligible dividends under the corporate leveraged insurance strategy. In general, the corporate leveraged insurance strategy provides the highest annual after-tax income and eligible dividends have widened this gap, improving values even further.

Are RCAs for owner-managers dead? Perhaps. Certain circumstances may cause one to reconsider this conclusion – moving to a tax haven or low tax treaty jurisdiction where the only level of tax paid in retirement on RCA payments is Canadian withholding tax<sup>[31]</sup> and possibly, if front end leverage of the RCA (FELRCA) is being considered. Also, it should be noted that the new dividend tax regime would have no bearing on the rationale for RCAs for arm's-length employee situations.

The possibility of front-end leverage should not be oversold. While the FELRCA may provide the corporation with more upfront capital for business purposes than bonusing down or retaining the cash at the corporate level and paying the high active business rate of tax, that shouldn't be where the analysis ends.

The FELRCA is a complex financial structure <sup>[32]</sup> which involves upfront bank fees as well as ongoing professional (legal, accounting, actuarial) costs. These costs would reduce the financial benefits in the early years and should be factored into the analysis. Ongoing interest costs should also be considered in determining the net cash flow impact to the corporation.

From a corporate perspective, the cost of generating the added cash by using the leveraged RCA would have to be compared to the return generated by investing that additional cash in the business.

In considering the use of a leveraged RCA structure, it must be understood that the analysis must continue through retirement. The terms of the RCA will require that the arrangement provide income in retirement. Therefore, in evaluating the benefits of the strategy, one must not only analyze its viability today but also the effectiveness of it as a retirement income producing strategy.

As with a non-leveraged RCA, the comparison should take into account the tax cost of receiving income out of an RCA vs. receiving dividends. So while increased upfront corporate cash flow may be available under a FELRCA, at the time retirement payments commence there will be a significant disparity in taxation to the owner-manager. This difference may prove to be a deterrent to using the leveraged RCA given the shift in thinking generally towards retention of earnings at the corporate level. Again, it may not be as big a deterrent if the retiree is intending to become a non-resident during retirement, assuming that the tax consequences of receiving such income in the non-resident jurisdiction are favourable.[\[33\]](#)

The FELRCA also brings with it certain risks which the other alternatives simply do not. For example, the CRA has questioned the validity of the RCA where leveraging is involved.[\[34\]](#)

## **Preference for Dividends over Capital Gains – Buy-Sell Planning**

To the extent that eligible dividends are not distributed and surplus is annually retained by the corporation, the GRIP can increase over time.

In planning for the death of a shareholder the availability of the GRIP should be contemplated. While eligible dividends must be taxable dividends, this includes deemed dividends. Share redemption strategies will often result in deemed dividends. Where life insurance is involved, deemed dividends may be elected to be capital dividends. Any taxable dividends not elected to be capital dividends may be designated as an eligible dividend to the extent the corporation has a GRIP. This would improve the tax benefits of strategies like the 50% solution, since the taxable part of the deemed dividend would be taxed at the lower eligible dividend rate rather than if that dividend were non-eligible.

Buy-sell agreements may need to contemplate hybrid approaches that bring about varying tax treatment depending upon the tax preferences and availability of GRIP. Recognizing that there will be potentially divergent interests at death between the survivor and the deceased, it is advisable to contemplate whose interests are going to prevail. It is probable that this will make drafting shareholders agreements which contemplate the tax attributes of various strategies considerably more complex. It may also be advisable for clients with existing shareholder agreements to meet with their tax advisors to revisit the buy-sell methodology in light of the new dividend tax rules.

In general, use of the promissory note method to the extent of any capital gains exemption and the use of the 50% solution in respect of the remaining value is the most likely middle ground between pursuing the preferences of the deceased or the survivor(s) only. Corporate-owned life insurance may be used to facilitate a buy-out resulting in dividend treatment by way of a redemption method and capital gains treatment by way of the promissory note method.

Buy-sell obligations without insurance funding will likely shift to redemption methods in situations where the corporation has a GRIP and eligible dividend rates are lower than capital gains tax rates.

## Preference for Dividends over Capital Gains – Business Succession Planning

In the context of post-mortem estate planning for a deceased shareholder (commonly where a family business is being passed on to the next generation), the preference to receive eligible dividends again may change the tax planning that is implemented to avoid double taxation. Previously, with the preference for capital gains as opposed to dividend treatment, consideration was given to “pipeline” and 88(1) (d) bump strategies which bring about capital gains treatment. [\[9\]](#) As a result of the new dividend tax rules, at least to the extent of any GRIP, redemption and loss carry back strategies [\[10\]](#) may be a more attractive planning strategy. Integrating life insurance into these strategies improves the overall tax result since life insurance enables the creation of tax-free capital dividends. In essence, the 50% solution, which requires a mix of capital and taxable dividends to be paid, will likely be the preferred route to the extent that eligible dividends can be paid to the estate.

## Conclusion

The introduction of the eligible dividend rules bring about a new planning landscape. Traditional corporate and insurance planning should be examined in light of these new rules. In most instances, there is a positive impact on corporate-owned life insurance planning strategies since the use of eligible dividends improves the tax results of both non-insurance and insurance-funded redemption and dividend producing strategies. Insurance-funded RCA planning should be compared to other insurance-funded strategies to determine if they remain viable options.

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## Endnotes

[1] Department of Finance News Release 2005-082, Nov. 23, 2005.

[2] Clause 20 Notice of Ways and Means Motion to Amend the Income Tax Act contained in the 2006 Federal Budget Tax Measures: Supplementary Information, Annex 3 at p. 309.

[3] Department of Finance Press Release 2006-028 dated June 29, 2006, announced release of Legislative Proposals and Explanatory Notes Relating to Income Tax Dividend Taxation.

[4] Bill C-28, Budget Implementation Act, 2006, No. 2, received Royal Assent, Feb. 21, 2007.

[5] From 19.58% in 2005 to 14.55% in 2006.

[6] From 25% to 45%.

[7] From 13.33% to 18.966% of grossed-up dividends.

[8] Definition in subsection 89(1) of the Income Tax Act, R.S.C. 1985, c. 1 (5<sup>th</sup> Supplement), as amended, hereinafter referred to as the “Act”. Unless otherwise stated, statutory references in this article are to the Act.

[9] Ibid.

[10] Supra note 8.

[11] Subsection 89(7).

[12] Subsections 89(4) and (8).

[13] Subsection 89(11).

[14] Subsection 89(14).

[15] Section 185.1 of the Act.

[16] Subsection 185.2(3) of the Act.

[17] Subsection 185.2(1) of the Act.

[18] Subsection 185.1(2) of the Act.

[19] Assuming refundable dividend tax on hand is not available. See discussion below under footnote 21.

[20] This is referred to as a “quirk” in the system in an article by David Louis published by Minden Gross entitled “Eligible Dividend Legislation: Some Comments”. In particular he writes, “if a company pays Part IV tax on an otherwise eligible dividend, this should be higher than the tax ultimately paid by the individual recipient. And since dividend refunds stem from taxable dividends (eligible or otherwise) there appears to be nothing stopping a corporation from paying an eligible dividend, while at the same time getting a dividend refund – provided, of course, it has the appropriate tax accounts.”

[21] Where refundable dividend tax on hand is available, the general order of preference can be first to receive eligible dividends with RDTOH recovery, then to ineligible dividends with RDTOH recovery, then eligible dividends without RDTOH recovery, then capital gains, then ineligible dividends without RDTOH recovery.

[22] For purposes of the examples in this paper, the impacts of the claw back of the small business deduction in Ontario has been ignored. That is, the examples assume that Opco earns in excess of \$1.1 million. In Ontario, claw back of the small business deduction occurs between \$400,000 and \$1,128,519 (for 2007) at a rate of 4.667% (for non-M&P income). This would result in an effective tax rate between these income levels of 40.79%. This example therefore assumes that the \$1 million of corporate earnings under consideration is above the \$1.1 million threshold so that it is more likely that the corporation would retain the corporate earnings as opposed to pay a bonus. If income levels of the corporation are within the \$400,000 - \$1.1 million corridor, it is likely that the preference would be to still bonus down to \$400,000 of corporate income.

[23] Ontario Employer Health Tax at 1.95% would be levied on bonus amounts. In this example this would reduce the net bonus payable in respect of this example from \$540,000 to \$529,670, reducing the cash flow to the corporation accordingly.

[24] Increases to the “general rate reduction percentage” out to 2009 from the 2006 Federal Budget proposals are found in S.C. 2006 c. 4 s. 73(1) which received Royal Assent June 22, 2006. Further reductions out to 2011 were proposed in the Notice of Ways and Means Motion to Amend the Income Tax Act, released by the Department of Finance dated Nov. 2, 2006, relating to a number of tax measures announced in News Release No. 2006-061, dated Oct. 31, 2006. These measures were subsequently included in Bill C-52 Budget Implementation Act 2007 at clause 14 which received Royal Assent June 22, 2007.

[25] Supra note 10.

[26] While there is still a tax cost (i.e. all in after-tax) on the ultimate distribution of a dividend when compared to the payment of a bonus, this will decline until 2011 as a result of proposed reductions in both the federal general corporate tax rate and enhancements to the provincial dividend tax credit. For 2007:

Bonus after-tax amount (shareholder loan)	<u>\$ 540,000</u>
After-tax corporate earnings (paid as a dividend)	\$ 640,000
Personal tax on dividend @ 25%*	<u>(\$160,000)</u>
Net after-tax cash to shareholder	<u>\$ 480,000</u>

\*By 2010 the tax rate is proposed to be approximately 22% resulting in tax of \$140,800 and net cash to shareholder of \$499,200. Again, still a tax cost but the gap is narrowing. The difference is paying either \$460,000 in tax now (on the bonus) or paying \$360,000 in tax now (at the general corporate rate) and \$140,800 later (in the shareholder's hands).

[27] Subsection 70(5) of the Act.

[28] Michael Cadesky presented this view in a presentation entitled "Impact of Change in the Dividend Tax Credit on Financial Planning" at the CALU Associates Members Meeting on Nov. 3, 2006.

[29] Definition of "capital dividend" in subsection 89(1) of the Act provides a private corporation that is the beneficiary of a life insurance policy with a credit of the death benefit in excess of the corporation's adjusted cost basis in the policy.

[30] Subsection 110.6 (1) definition of "qualified small business corporation share".

[31] 25% for non-treaty jurisdictions and generally 15% for pension income in most of Canada's Income Tax Treaties.

[32] For a more complete discussion of this strategy and the impact of the new eligible dividend tax regime on see 2007 Insurance Planning, Vol. XIII.

[33] Supra note 31.

[34] #2005-0132401I7 dated Sept. 16, 2005, and Question 12 at the APFF CRA Roundtable dated Oct. 14, 2005.

[35] The pipeline strategy is a post-mortem planning strategy designed to obtain capital gains treatment at death. To do this, subsection 70(5) is allowed to operate at death to trigger a deemed disposition of the shares at death. This triggers a capital gain, and tax is paid accordingly. In order to avoid double taxation of any future extraction of assets from the company, planning is undertaken to create a “pipeline” through which assets equal to the gain realized at death can be extracted from the corporation on a tax-free basis. Essentially the ACB is “incorporated” and converted into a note payable. Usually this is accomplished by transferring the shares of the corporation to a new holding company and in exchange for low PUC/ACB shares of the holding company and a promissory note from the holding company equal to the ACB of the shares transferred.

The 88(1) (d) bump is a provision of the Act which allows the adjusted cost basis of some of a corporation’s underlying assets to be “bumped up” or increased to reflect a higher cost base inherent in the shares of the corporation. The purpose of this is to ensure that when those assets are distributed or sold, to the extent that the gain on the shares of the corporation has already been taxed, there will not be taxation on the same gains inherent in the underlying assets.

For more information relating to this planning strategy see February 2007 *CALU Report* “Post Mortem Planning Update” by Chris F. Ireland.

[36] Subsection 164(6) of the Act which allows losses arising in the estate (including those which arise as a result of a share redemption) to be carried back to an individual’s terminal return to offset gains arising in the year of death as a result of deemed dispositions at death.

## About the Author

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