Making life less taxing for one's heirs

MERRICK WEALTH

By Peter Merrick

It was a winter afternoon in Toronto when Richard Segal of The PanFinancial Group and I met with Robert. A successful businessman in his early 70s, Robert had spent over $100,000 in fees for lawyers and public accountants. All he wanted to do was to create an estate plan that would reduce taxes upon his death.

Even though his existing estate plan alleviated many of his tax issues, Robert still had over $10 million in cash or near cash held in his corporate structure, which would be fully taxable as capital gains when he died.

His estate plan had not provided him or his heirs with a satisfactory solution to reduce or eliminate these taxes.

Robert had come into our offices to find out if there were alternative or complementary solutions that would alleviate this pending burden.

In the financial planning community the 'holy grail' of all strategies is the little-known structure called the corporate capital gain solution. It has been used successfully for over 20 years.

Few know about this and only a very few skilled professionals have the expertise to implement and maintain the solution for corporate clients.

Segal was one of those rare professionals.

This solution couldn't have been more perfect to resolve Robert's dilemma. In essence, the solution is as follows:

• A corporation acquires an annuity, and an insurance policy on the life of its key shareholder.

•The corporation then borrows funds to replace the capital used to purchase the annuity.

• The annuity payment pays the insurance premium and the loan interest.

•The capital gain on disposition of the shares of the company is reduced by the amount of the loan.

The end result is, upon your client's death, capital gains taxes are eliminated on the disposal of the client's corporate shares. One of the nice results is the client is cash neutral during the entire process.

Here is how it works.

• The first stage involves the purchase by a corporation of an immediate annuity on the life of a key shareholder. This is generally accomplished with the payment of a lump sum amount to the life insurance company.

• The second stage is the purchase of an insurance policy on the key shareholder's life.

• The third stage is the corporation borrows funds to replace the capital and, where desired, it can be used to re-acquire any liquidated assets.

While the shareholder is alive the corporation will receive payments under the annuity contract. The annuity payments after tax are sufficient to pay the insurance premium and the interest on the loan.

Interest paid on the borrowed funds is deductible.

In addition as the insurance policy acquired by the corporation is required as collateral for the loan the lesser of the policy premium and the policy's net cost of pure insurance will be deductible from the corporation's income.

Immediately before death, the shareholder is deemed to have disposed of his or her shares of the corporation for their fair market value.

The amount of the loan reduces the value of the shares. However, the value of the annuity and of an insurance policy without cash surrender value is nil. Therefore, there would be a reduction in the value of the corporation for income tax purposes.

This results in significant tax savings to the deceased's estate.

The amount of any insurance proceeds paid to the corporation, net of the adjusted cost basis of the insurance policy, would be credited to the corporation's capital dividend account.

This would allow the payment of capital dividends to the estate of the deceased shareholder, i.e. a tax-free distribution that would be unavailable without the life insurance component of the corporate capital gain solution.

Funds received by the estate in this fashion could be used for the payment of bequests, income tax and other estate liabilities.

In Robert's situation his savings were very substantial as a result of implementing the solution.

A $10 million annuity was purchased along with a $10 million insurance policy. A loan using the life insurance and annuity as collateral for the $10 million was set up.

Upon Robert's death, the value of the company will be reduced by the $10 million loan. This reduces the capital gain by $10 million.

This will be a tax saving to Robert's estate of $2,320,050 assuming a 46.41 per cent tax rate (the Ontario tax rate). This results in the $10 million of assets held in Robert's corporate structure, that would have been fully taxable as capital gains on his death, passing on to his heirs tax free.

As Segal said to Robert in closing: "This is one occasion where you are able to eliminate a substantial amount of tax at no cost to you. In addition, the way we have structured this has reduced the risk of an increase in interest rates."

When implemented properly and for the right reasons, the corporate capital gain solution should be considered as corner tone of a well-planned and balanced financial and estate plan. This solution is a powerful and attractive alternative within the accountant's tool kit.

Peter J. Merrick, BA, FMA, CFP, FCSI, is the president of Merrick-Wealth.com, a fee-for-service financial planning and executive benefit consulting firm in Toronto. He is the author of "The Essential Individual Pension Plan Handbook" (Lexis-Nexis Canada, 2007). He can be contacted at: (416) 854-1776 or *peter@merrickwealth.com.*