Live *your* dream.

Live Your Dream Report

The Hidden Estate Tax ~ Issue 8

We are often asked "*Do estate taxes apply in Canada as in other countries?*" The answer is that in Canada, a person's assets are not taxed upon death but are considered to have been disposed of or sold. However, this requirement has tax implications that may have quite an effect on your estate. If your dream is to leave your cottage or business to future generations, then a little bit of planning will go a long way to help maximize your estate.

Personal Possessions

You may have acquired property that has increased in value since you bought it. Perhaps you obtained your family cottage at a low price prior to the current demand for vacation property, or maybe the art-buying public now shares your taste for obscure works of art. In either case, you have possessions that are worth far more than what you originally paid for them.

Your Business

You may have started from scratch or with relatively little initial investment and built a successful business. The effort you devoted has resulted in a sizable increase in the market value of your business as your surplus has grown and debt has been reduced. At this point, the value of your business may have increased well beyond your initial investment.

Capital Gains Tax

In either case, the growth in the value of your property carries a hidden liability. For example, if you die or sell the shares of your business, or decide to sell the family cottage, a capital gains tax is applied to the amount by which the value of your property exceeds your investment. When planning your estate, it is important to ensure that it has enough liquid capital to cover this potential tax.

Possible Consequences

It is a little known fact, but many cottages and businesses are sold upon the owner's death, not because the owner did not want the heirs to have them but because the heirs did not have the money to pay the taxes owing. Heirs are often placed in the unfortunate situation of having to sell the assets, on occasion well below market value just to cover the capital gains tax.

For example:

Your family purchased a cottage for $50,000 ten years ago. Since that time, property values in your area have escalated. When you and your spouse both pass away (*assets can be transferred between spouses tax free*), the cottage has a value of $450,000. This means there is a $400,000 capital gain that will be taxed upon the death of both spouses. 50 percent or $200,000 of the gain is taxed at an assumed marginal tax rate of 40 per cent, which results in $80,000 in outstanding taxes. Unless your heirs can come up with the $80,000, they may be forced to sell the cottage to pay the taxes.

Possible resolutions

Several strategies can be used to pay the outstanding capital gains tax:

1. Ignore the problem. Many people simply inform their heirs that if they want the property or business they should start saving to pay the tax.

2. A savings program. You can put aside a monthly amount earmarked for the payment or partial payment of capital gains tax.

3. Joint-Last-to-Die life insurance. The proceeds of this type of life insurance policy come due upon the death of both spouses. They also go directly to the named beneficiaries on a tax-free basis. The only disadvantage is that insurance premiums must be funded with personal after-tax dollars.

4. Buy Insurance through the corporation. Business shares, however, can be dealt with differently. The owners of an incorporated business have the option of buying insurance through the corporation using corporate dollars to pay the premiums. When the owner dies, the business receives the life insurance proceeds tax-free. It can use the funds to declare a tax-free dividend to the shareholders so that they can purchase the shares from the estate of the deceased. Or the money can be used to redeem the shares of the deceased shareholder directly, thereby providing the cash necessary to pay the tax. When dealing with the capital gains on business shares, particular care must be exercised to avoid undesirable tax consequences.

These are just some of the issues that should be addressed in an overall estate plan. If you are interested in reviewing your estate plan, please call our office for an appointment.

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