Tax Topics

March 23, 2021
Number 2559

COVID-19 Update

# TAX PLANNING FOR THE NON-SPECIALIST ADVISOR
# POST-MORTEM PLANNING FOR PRIVATE COMPANIES — RECONSIDERING THE OPTIONS FOR TRIGGERING CAPITAL GAINS — PART I

*Michael Goldberg, BComm, LLB, TEP, FEA, Partner, Tax Lawyer, Minden Gross LLP, MERITAS© Law Firms Worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant, and real life situations for professional advisors who serve high net worth clients.*

Special thanks to Cy M. Fien, Fillmore Riley LLP, who after all these years continues to teach and mentor me, including providing invaluable technical and practical insights that have greatly improved this Series.

## Private Corporation ("PC") Liquidation Planning on Death

Let's face it: post-mortem planning for clients with material interests in PCs is ridiculously complex!

There are so many options that tax professionals, advisors, and executors must take into consideration these days that it literally boggles the mind.

In Part I of this two-part series of articles (the "Series"), at a high level, we will review some of the primary income tax-related planning tools associated with tax planning on death, including some issues complicating the implementation of certain of these planning tools that are often employed in PC Liquidation (as defined herein) situations. In Part II of the Series, we will explore an alternative strategy, that I call "Spousal Rollover Liquidation Planning". This strategy may, in appropriate circumstances, offer a number of advantages over many of the primary post-mortem PC Liquidation planning tools, including being much more straightforward to implement, while still enjoying comparable tax results.

*************

## Subsection 70(5) — Primary Income Tax Related Planning Tools

The primary income tax related planning tools to manage taxes resulting from the deemed disposition of an individual's capital property immediately prior to his or her death due to the application of subsection 70(5) of the *Income Tax Act* (Canada) (the "Act")[1] are:

[1] R.S.C. 1985, c.1 (5th Supp.), as amended. Unless otherwise provided, all statutory references herein are to the Act.

(1) when a deceased person (a "Decedent") leaves a surviving spouse,[2] taking advantage of the rollover opportunities available in connection with property of the Decedent[3] that, within 36 months of the death of the Decedent, vests indefeasibly in the spouse or a qualifying trust for the benefit of that spouse in accordance with subsection 70(6) (a "Spousal Trust"; both types of rollovers are referred to herein as "Spousal Rollovers");[4]

(2) making use of subsection 164(6) to carry back capital losses realized by an estate in its first taxation year to reduce (or even eliminate) the tax on deemed capital gains on death ("Subsection 164(6) Planning"). However, depending on the particular situation, the "price" of implementing Subsection 164(6) Planning may be to substitute capital gains taxes in the Decedent's terminal return with potentially more costly taxable dividends in the estate's first taxation year;[5]

(3) planning that can be used to remove property from a PC using the adjusted cost base[6] ("ACB") in shares, including ACB created as a consequence of a deemed disposition on death pursuant to subsection 70(5), without giving rise to additional tax at the estate/beneficiary level ("Pipeline Planning");[7]

(4) planning that utilizes the provisions of paragraph 88(1)(*d*) to increase or "bump" the ACB of non-depreciable corporate capital properties, for example, land, shares, or partnership interests, using the ACB of a Decedent's PC shares ("Paragraph 88(1)(*d*) Bump Planning");[8] and

(5) planning that combines any one or more of the above ("Hybrid Planning").[9]

Whether any particular plan or combination of plans will be the most efficient tax-wise can only be determined on a case-by-case basis.

It is important to keep in mind that careful drafting of wills is always advisable, and will be critical if there is any possibility that post-mortem planning, including planning involving any of the strategies described in this Series, is to be implemented.

## Reasons To Liquidate a PC

The liquidation of an estate's interests in a PC,[10] which in some situations may involve a partial or even the full liquidation of the properties held by the PC as well as the repurchase of the interests of the estate in the PC or even the wind-up of the PC (collectively, all such liquidation situations are referred to as "PC Liquidations"), as part of post-mortem planning may be desirable for a number of reasons, including:

(1) managing the amount of subsection 70(5) taxes, for example, using some of the post-mortem tax strategies described above;[11]

---

[2] In the Series, any reference to the term "spouse" includes a reference to a common-law partner, as that term is defined in subsection 248(1).

[3] The Act contains no concept of "substituted property" for purposes of subsection 70(6).

[4] Although the Act contains other post-mortem rollover opportunities, for example rollovers to children in respect of "farming and fishing property" (see subsection 70(9) and related provisions) and/or a "share of the capital stock of a family farm or fishing corporation" (as that term is defined in subsection 70(10)), only Spousal Rollovers will be discussed in the Series.

[5] Not all taxable dividends received by an estate will result in net increases in post-mortem taxes. In particular, post-mortem planning involving an estate receiving taxable dividends that also results in a refund of eligible or ineligible refundable dividend tax on hand (collectively, "RDTOH") to a PC can be tax efficient since the estate level tax from such dividends net of the refund of RDTOH to the PC will be less than the tax to the Decedent under subsection 70(5).

[6] As that term is defined in section 54.

[7] In the event that the ACB and fair market value ("FMV") of property that is to be removed from the PC are not equal to one another, then Pipeline Planning may give rise to taxes in the PC.

[8] Paragraph 88(1)(*d*) Bump Planning tends to be particularly useful if the Decedent controlled the PC immediately before death since the Act contains specific rules that will typically allow the paragraph 88(1)(*d*) bump to increase the ACBs of non-depreciable capital properties owned by the PC to their FMV as at the date of death of the Decedent. See in particular, paragraph 88(2)(*d*.3).

[9] The foregoing ignores the interaction of many practical tax and non-tax related issues that can impact post-mortem planning, including but not limited to the interaction of post-mortem planning with: charitable planning; insurance planning; *inter vivos* trust planning, including trusts used for estate freeze and/or lifetime trust purposes, equalization planning, cross-border beneficiary planning, and so on.

[10] Or any private investment vehicle (e.g., a partnership) where subsection 70(5) will not increase the ACB of assets owned within the investment vehicle. In the Series, only planning involving PCs will be discussed.

[11] Subsection 70(5) will not increase the ACB of assets owned within an investment vehicle such as a PC. In the absence of implementing post-mortem planning of the nature described in the Series, the failure of the death of a Decedent to increase the ACB of the underlying assets of the PC could create double taxation or worse. This is because tax will be payable by the Decedent on his or her death at capital gains rates. In addition, in the event that there is a future PC Liquidation, taxes may be paid by the PC and by the estate or estate beneficiaries when the assets of the PC are distributed to them. Finally, while it is possible that the future PC Liquidation may give rise to capital losses (as discussed below, losses may be restricted or denied in some situations), if the estate or estate beneficiaries have no use for capital losses, the capital losses may have little or no value.

(2) creating liquidity, for example, to fund bequests, charitable gifts,[12] tax liabilities, and/or the costs of operating the estate;

(3) a desire to simplify ongoing compliance and/or complexity involving the administration of an estate and/or trusts formed under an estate;

(4) addressing executor concerns about potential tax rate changes (e.g., future tax increases that may negate or reduce the benefits of a tax deferral);

(5) assisting executors to manage difficulties in agreeing on the value of portions of a residue where some portions of the residue have full cost base and other portions of the residue have been subject to a Spousal Rollover; and

(6) reducing the need for complex planning on the death of the second spouse.

Interestingly, even in situations involving wills that provide for Spousal Rollovers, we are encountering situations where the executors of estates are considering foregoing the potential Spousal Rollover tax deferral for many of the reasons noted above.

While these PC Liquidation situations would seem to be ripe for the implementation of Subsection 164(6) Planning, Pipeline Planning, Paragraph 88(1)(*d*) Planning, or Hybrid Planning (collectively referred to as "Traditional Post-Mortem PC Planning Techniques"), in Part II of this Series I'll muddy the planning waters even further by suggesting the use of a different post-mortem planning approach that I call "Spousal Rollover Liquidation Planning". Before examining this approach, let's review some of the complicating issues associated with the Traditional Post-Mortem PC Planning Techniques.[13]

## Some Issues Complicating Subsection 164(6) Planning

Only a graduated rate estate ("GRE")[14] can utilize Subsection 164(6) Planning. In addition, as set out in the preamble to subsection 164(6), the steps necessary to implement Subsection 164(6) Planning must be completed before the first anniversary of the death of a Decedent.

As discussed previously, subsection 164(6) can be used to carry back capital losses realized by an estate in its first taxation year to offset capital gains realized in a Decedent's terminal taxation year. However, there are a plethora of loss restriction provisions in the Act that can restrict or even deny the use of capital losses and many of these provisions will need to be reviewed in connection with Subsection 164(6) Planning.

In general, subsection 40(3.4) will restrict and subsection 40(3.6) will deny[15] a taxpayer's capital loss claim in connection with a disposition or deemed disposition of shares of a corporation with which the taxpayer is affiliated.[16] However, in the context of Subsection 164(6) Planning, pursuant to subsection 40(3.61), provided that an estate is a GRE, capital losses carried back to the terminal taxation year of a Decedent under subsection 164(6) will be exempted from the application of subsections 40(3.4) and (3.6).

In the past, concerns had been raised that the provisions of the Act could iteratively cause the capital losses associated with shares of an affiliated PC that would otherwise be available for Subsection 164(6) Planning purposes to be denied if an estate had realized capital gains in its first taxation year.[17] Thankfully, at the 2020 STEP Round Table on November 26, 2020, the Canada Revenue Agency ("CRA") indicated that it would not interpret the Act in this manner. As a result, according to the CRA the full amount of the net capital losses available to be carried back to the terminal taxation year of a Decedent would be available for carryback under subsection 164(6).[18]

Because subsection 40(3.61) only exempts subsection 164(6) loss carrybacks, assuming that the estate's capital losses arose in respect of shares of a PC with which the estate is affiliated, then pursuant to the ordinary operation of

[12] Rather than liquidating appreciated public company shares that have been subject to subsection 70(5) and using cash to make post-mortem charitable gifts, consideration should be given to arranging for an estate that is a graduated rate estate ("GRE") (as defined below) to satisfy its charitable obligations by making direct donations of the public company shares in order to take advantage of the rules in subparagraph 38(*a*.1)(ii), which will cause those particular capital gains to be zero.

[13] For a recent article summarizing a number of these and other post-mortem planning options, see: Erin Podio and David Stevens, *Update on Post-Mortem Planning*, 2018 Ontario Tax Conference, 7: 1 – 38 at page 28. While a bit dated, I find a series of articles entitled *Estate Planning in the 21st Century* by my late partner David Louis, Michael Atlas, and Brian Nichols that were published in CCH Canadian Limited's Tax Topics from 2002 – 2004 particularly reader friendly and useful.

[14] As that term is defined in subsection 248(1).

[15] In accordance with paragraph 40(3.6)(*b*) the capital loss denial may be accompanied by an addition to ACB of remaining shares, if any.

[16] As that term is defined in section 251.1.

[17] Nick Moraitis and Manu Kakkar, *Potential Circularity Problem with Estate Loss Carryback* 2006 Tax for the Owner-Manager 6(3):6 – 7.

[18] Question 5. See also Brian Nichols and Kelsey Horning, *Shift in CRA Position on Circularity Between Implications of Subsection 164(6) and Subsections 40(3.6) to (3.61)* Tax Topics 2548, January 5, 2021.

subsections 40(3.4) and/or (3.6),[19] the estate will not be entitled to offset any capital gains realized by it[20] in its first (or any other) taxation year with those PC capital losses that were not carried back to the terminal return.

Even if one is able to manage the loss restriction rules in subsections 40(3.4) and (3.6), other loss restriction rules in the Act still need to be considered on the repurchase of PC shares. In particular, the rules in subsection 112(3.2) could reduce capital losses available to trusts, including Spousal Trusts, in respect of shares upon which tax-advantaged dividends have been received.[21]

Additional complications that may impact subsection 164(6) planning include the possibility that, in some cases, Part VI.1 taxes could be applicable.

## Some Issues Complicating Pipeline Planning and Paragraph 88(1)(*d*) Planning

Currently, provided that taxpayers follow CRA administrative commentary, including certain timing delays, the CRA accepts Pipeline Planning as an effective means of post-mortem planning that, in appropriate situations, can be used to tax-efficiently remove property from a PC.[22] However, recent changes to the Act introducing section 212.1 could apply to deny benefits available using a Pipeline Planning strategy for an estate with non-resident beneficiaries by converting the otherwise tax-free transactions into taxable dividends subject to withholding taxes. Fortunately, on December 2, 2019, the Department of Finance issued a comfort letter indicating that, under certain limited circumstances, relief from the application of the section 212.1 rules will be provided.[23]

While Paragraph 88(1)(*d*) Planning will often be beneficial in connection with post-mortem planning involving PCs, the technical rules associated with this planning are complex and, in many situations, the rules may be unavailable or be subject to both practical and technical restrictions.[24]

Unfortunately, the corporate reorganization costs associated with the implementation of Pipeline Planning and Paragraph 88(1)(*d*) Planning are typically not insignificant and may be prohibitive in some situations. Also, in many cases the best post-mortem planning may involve combining one or more of the Traditional Post-Mortem PC Planning Techniques, which can create further complexities and costs.

---

[19] If capital losses are realized in connection with the wind-up of a corporation, it appears that subsection 40(3.6) should not be applicable. For example, see CRA Document No. 9325537 dated November 24, 1993, which seems to confirm that it is the CRA's policy not to disallow a loss on the wind-up, even if legal existence has not yet been cancelled. In addition, based on paragraph 9 of IT-126R2 (Archived), the CRA will generally allow losses to be claimed on the wind-up of the corporation, as long as all assets have been distributed and liabilities settled by the end of the first taxation year of the estate, even though formal dissolution has not been completed. This is particularly relevant in the case of corporations governed by the *Business Corporations Act* (Ontario), R.S.O. 1990, c. B.16, where Ontario tax clearance is required prior to filing Articles of Dissolution.

Non-affiliated PC capital losses, if any, realized during the first taxation year of an estate that are not subject to subsection 40(3.4) or (3.6) can be dealt with in accordance with the ordinary provisions of the Act, including subsection 164(6).

[20] When considering the application of subsections 40(3.4) and (3.6), advisors need to carefully consider whether capital gains have arisen in the estate, which may not always be immediately obvious. For example, where an estate holds interests in mutual fund trusts, the mutual fund trusts may make allocations of capital gains to the estate. Another possible source of capital gains could arise as a consequence of the security holdings of an estate being subject to a reorganization that is not tax deferred.

[21] For example, capital dividends, dividends allocated to corporate shareholders, etc. Limited relieving rules may be available to estates that are GREs (subparagraph 112(3.2)(*a*)(iii)). Separate stop-loss rules apply throughout section 112, including rules that apply specifically to trusts that have been subject to the deemed disposition rules in subsection 104(4) (subsection 112(3.3)).

Interestingly, even though CDA can be paid out of a PC to its shareholders tax free, in situations in which the stop-loss rules in subsection 112(3.2) would otherwise be applicable, a PC with RDTOH balances will generally benefit from paying the RDTOH out before CDA.

[22] Some examples of past CRA commentary include: Document No. 2009-0326961C6, October 9, 2009 and Document No. 2018-0748381C6, May 29, 2018.

[23] For more on this topic see, for example, Kyle B. Lamothe and Alexander Demner, *Section 212.1 Post Mortem Pipeline Comfort Letter* 2020 Tax for the Owner-Manager 20(2):8 – 9.

[24] A discussion of these restrictions is beyond the scope of this Series.

**TAX TOPICS**

Published weekly by Wolters Kluwer Canada Limited. For subscription information, see your Wolters Kluwer Account Manager or call 1-800-268-4522.

*For Wolters Kluwer Canada Limited*

*Email: cservice@wolterskluwer.com* *Phone: 1-800-268-4522 or (416) 224-2248 (Toronto)*

***Notice:*** *Readers are urged to consult their professional advisers prior to acting on the basis of material in Tax Topics.*

Wolters Kluwer Canada Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
1 800 268 4522 tel
1 800 461 4131 fax
www.wolterskluwer.ca



Wolters Kluwer