AVOIDING DOUBLE TAX
ON DEATH

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Introduction

Deemed dispositions on death for tax purposes set in motion a scenario that can result in double tax. There are, however, a number of possibilities in the estate planning and administration context that can reduce the exposure to double taxes. One strategy is to find a way to allow an estate or trust to apply capital losses against any capital gains arising from an individual's death. There are other strategies described in the paper that reduce or eliminate taxes at corporate or estate levels. Recent changes in tax rates and inclusion rates have altered the presumptions as to which is the best post mortem planning.

Subsection 164(6)[2] - Carrying Back Losses

Ordinarily, when a taxpayer dies, for taxation purposes the person is deemed to dispose of the capital assets he owned immediately before death for proceeds equal to the fair market value of the property[3]. The person who acquires the property as a result of the taxpayer's death is deemed to have acquired it at fair market value[4]. Assuming no rollover is available, unless action is taken by the estate trustee, this situation can lead to double taxation. Initially, the deceased taxpayer will be taxed on any deemed gain. If the capital assets are shares of a corporation or another intermediary, tax is often payable a second time upon the receipt of distributions from the intermediary. And chances are some of the assets held by the intermediary will require liquidation almost immediately in order to pay the tax arising from the deemed disposition. Subsection 164(6) generally assists in preventing this double taxation; a capital loss realized in

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1 The author would like to acknowledge the valuable assistance received from Karen Ballantyne, Articling Student, Goodman and Carr LLP. The slides used in the presentation are adapted from slides developed by Paul Bleiwas, Partner, Goodman and Carr LLP. Recent articles on the topic include "Spouse Trusts: Tips and Trips- Part I" by Pearl E. Schusheim, (1999), vol. 47, no. 6 *Canadian Tax Journal*, 1525-1544; "Testamentary Planning to Avoid Double Taxation" by H. Elise Rees, (2000), vol. 48, no. 1 *Canadian Tax Journal*, 155-172; and "Interspousal Property Transfers: The Things They Don't Tell You at the Diamond Shop" by M. Addison and J. Korn, (2002), vol. 50, no. 2 *Canadian Tax Journal*, 728-753

2 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended [hereinafter *ITA*]

3 *Supra*, note 2, s. 70(5)(a)

4 *Supra*, note 2, s. 70(5)(b)

the course of administering the estate can be carried back and used to offset the capital gain realized in the year of death.

There is often a very finite amount of time during which the estate trustee administers the assets prior to distributing the assets and winding up the estate. This interim period is critical in order to assess what planning should be undertaken. As a result of the death, during this period, in the absence of a rollover, any corporate shareholding held by the estate has an adjusted cost base equal to its fair market value immediately before the taxpayer's death. If the taxpayer owned, for example, shares of a closely held Canadian-controlled private corporation ("CCPC"), the estate trustee might be in a position to reduce the capital gain reported in the terminal tax return through the repurchase of the shares by the corporation or through the winding up of the corporation. Usually, this action will, to some extent (often significant), result in a taxable dividend being realized by the estate, and a capital loss will occur on the disposition resulting from the repurchase of the shares. These circumstances occur in respect of shares, because the tax system is geared to make corporate distributions from retained earnings taxable, irrespective of the share acquisition cost. If the filing requirements of subsection 164(6) are met, this capital loss can be carried back to the taxpayer's final tax year, and be used to offset any gains.

The subsection 164(6) loss carryback does have some strict qualifications. For example, the three year carryback provisions available to a continuing entity under section 111 do not apply; the loss can only be carried back to the final tax return of the deceased, and not to earlier years. This is generally satisfactory because the deemed realization intended to be offset is included in the terminal return. In addition, only losses in respect of transactions involving capital property can be carried back, and not losses resulting from the disposition of inventory. Another important restriction is that the capital loss must be realised by the estate within its first taxation year. This can lead to difficulties, some administrative, some practical and some technical. For instance, the timing of the realisation of a loss on the disposition of shares in the course of winding up is not particularly clear. The final dissolution does not strictly occur until the corporation is struck from the register and that is generally delayed pending resolving final tax matters, such as the final refund of the refundable dividend tax account. The CCRA will allow some leeway, and will consider the shares to have been disposed of within the first taxation year if the estate trustee has commenced the winding up process[5]. The estate trustee should continue to act without undue delay in winding up the corporation in order to provide firm evidence that the corporation is on a course to be dissolved shortly after the one year period. Prompt interim distribution of the corporation's assets to the shareholders is a helpful indicator.

An estate trustee must make an election in order to be eligible to carry the estate's capital losses back to offset the gain reported in the final tax return, and the election must be filed within the prescribed time and in the prescribed manner. If the election is not submitted by the appropriate deadline, the estate trustee may apply to the Minister of National Revenue for an extension, as per subsection 220(3.2). Regulation 1000 requires the estate trustee to file several documents that disclose the properties disposed of and a calculation of losses. Further, an amended final tax return for the deceased must be filed in most cases, although the CCRA will accept a T1 adjustment under certain circumstances[6].

Subsection 164(6) is neither required nor applicable where there is a rollover to a spousal trust; it is noteworthy that to use the provision, the property in question must have passed to the *estate* of the deceased taxpayer, rather than a specific trust. Sometimes a third party has a right to purchase property intended for a spousal trust. For instance, in a case where a shareholders' agreement requires a repurchase by a corporation of its shares from the estate that are earmarked for the spousal trust, there is no rollover, but the loss realized on the repurchase is permitted to be carried back to the taxpayer's final return.

Spousal Rollovers

As a result of same-sex partners legislation, the term spouse now includes married persons, common law spouses of the opposite sex and same-sex partners for the purposes of the *ITA*. This definition applied beginning in the 2001 taxation year, and taxpayers who would have qualified

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5 H. Elise Rees, "Testamentary Planning to Avoid Double Taxation" (2000), vol. 48, no. 1 *Canadian Tax Journal*, 155-172

6 Paragraph 164(6)(e) requires the filing of an amended return of income in the year the taxpayer died. However, if the losses are known before the return is actually filed, CCRA will permit the election to be reflected on the final return.

as common law partners under the new definition in any of the 1998, 1999 and 2000 taxation years were able in 2001 to make retroactive elections to have the definition apply for those years.[7] Thus, common law couples can now utilize the deferral advantages of spousal trusts for tax and estate planning.

Generally, when a taxpayer disposes of appreciated capital property, the capital gain is subject to tax. Further, where, in non-arms length circumstances, a taxpayer disposes of property for no proceeds or for proceeds less than fair market value, there is a deemed disposition at fair market value which results in capital gains. However, the *ITA* allows transfers by a taxpayer to a spouse, surviving spouse or qualifying spousal trust on a tax-deferred basis. The main qualification is that throughout the spouse's lifetime, the spouse is entitled to receive all of the trust's income and no other person has any entitlement to capital. The spouse (or spousal trust) receives the property at its adjusted cost base, and does not have to recognize capital gains until he or she disposes of the assets in turn. Notably, recent amendments to section 73 have created the possibility of joint spousal trusts and alter ego trusts, both trusts being timely additions to provide taxpayers with some flexibility in planning their affairs. Special considerations apply in order to ensure that double taxation can be avoided when these trusts are utilized.

i) Alter Ego and Joint Spousal and Common Law Partner Trusts ("Post 65 Trusts")

In order to create Post 65 Trusts that qualify for a section 73 rollover, the transferred property must be capital property of the transferor, and both spouses must be residents of Canada at the time of the transfer. The trust must be created after 1999, and the transferor must be age 65 or older when the trust is settled. In addition, for joint situations, the transfer itself must meet certain requirements. The settlor and/or spouse must be exclusively entitled to receive all of the income of the trust, and no other person but the settlor and his or her spouse can be entitled to the capital of the trust before their deaths.

There is a downside to Post 65 Trusts, as the income of these inter vivos trusts is subject to the highest federal and provincial rates of tax. Even upon the death of the settlor, an inter vivos

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[7] Bill C-23, S.C.2000, c.12, June 29, 2000 (in force July 31, 2000)

spousal trust will not be able to qualify for the usual graduated tax rates. In addition, the trust is not eligible to claim any personal exemptions that would be available to the deceased in the year of death. Losses that may occur are trapped in the trust and cannot be carried back against the deceased's income from prior years (although they can be carried forward to future trust taxation years). Quite significantly, there is a deemed disposition to the trust on the death of the last of the required income beneficiaries.

ii) Inter Vivos and Testamentary Spousal Trusts

Spousal trusts are commonly used to ensure gains are not recognized unduly prematurely. In the case of testamentary trusts, within thirty-six months (or a longer period where it may be reasonable in the circumstances) after the death of the taxpayer, the property must vest in the spouse or spousal trust. Arguably, the wait for a tax clearance certificate should constitute a reasonable circumstance.

Inter vivos and testamentary spousal trusts allow for a tax-free rollover of assets, provide the settlor's or testator's spouse with an income during his or her lifetime, and can be used to specify contingent beneficiaries of the estate upon the death of the spouse. These trusts can be a particularly useful planning tool when the testator has intended beneficiaries from an earlier marriage, as the bequests to children from a former marriage can be buttressed while providing a lifetime income entitlement to a current or surviving spouse.

Testamentary spousal trusts are generally preferable to Post 65 Trusts (which are sometimes recommended in substitution) as they are only subject to tax at graduated income tax rates. However, as with inter vivos trusts, testamentary trusts do not benefit from the basic personal exemption extended to individuals.

iii) Qualifying Trusts - Generally

The provisions of subsection 164(6) are not applicable, or necessary, for Post 65 Trusts or spousal trusts, since assets transferred to these trusts are transferred at cost, and there is no deemed disposition to the settlor or testator. The settlor or deceased does not have to pay tax on any gains on property passing to qualifying trusts, as the tax is deferred for the time being.

When the spouse dies, the assets of a spousal trust are deemed to have been disposed of at fair market value on the day of death[8]. Accordingly, the spousal trust is taxed on any accrued capital gain, and the issue of double taxation arises again. The question is whether any subsequent capital losses on the assets can be set off against the spousal trust's capital gain. As explained in more detail below, as long as the trust itself continues, capital losses can be carried back, despite the fact that the deemed disposition arose on the spouse's death and the spouse is no longer a beneficiary.

Continuation Periods For Qualifying Trusts

In the case of shares in a CCPC, planning as previously described can be implemented to repurchase the shares and either apply or carry back the loss to offset the spousal trust's capital gain. Subject to the specific terms of the trust or any applicable legislation, the death of a beneficiary does not terminate the obligation of the trustees to administer the trust's property. Notably, there is no deemed year end for the trust when a spouse dies, and the trust will have its regular inter vivos testamentary year end unless it is actually wound up in that taxation year. Where the trust is wound up, the trust's year end will generally be on the date when the last of the assets are distributed.

Sometimes it is difficult to determine when the trust is at an end, and for each case, it is a question of fact. It is necessary to look to the relevant laws of the applicable province, as well as the relevant document constituting the trust. This raises an interesting issue: whether the terms of a spousal trust will permit the trust to continue after the death of the surviving spouse. The question has been raised, albeit not really answered, in a CCRA Technical Interpretation [9]. To avoid ambiguity it is recommended that the trust document specifically provide that the trust continues on the death of the spouse. Then, a plan to repurchase shares of the corporation, create

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8 *Supra*, note 2, s. 104(4)

9 Document Number 9714075, August 11, 1997

a loss and use it to offset the gain may be undertaken with certainty. The capital gain and loss created in the spousal trust will be governed by the normal provisions of the *ITA* in respect of capital transactions. The trustee of a spousal trust that continues for three years can take full advantage of the net capital loss carryback provisions of paragraph 111(1)(a). However, it should be noted that the stop-loss rules (discussed below) under subsections 112(3.2) and 40(3.6) apply equally to losses in estates and trusts.

There is no *ITA* provision allowing for capital losses realized by the residuary beneficiaries to be applied against capital gains realized in a spousal trust as a result of the surviving spouse's death. Similarly the gains arising in the trust on the spouse's death are required to be taxed in the trust, without any flow through designation allowed to the beneficiaries.

Another issue that could arise when drafting and implementing a spousal trust is whether the terms of the trust will allow it to retract or dispose of any shares that are trust property. If freeze shares are left to a spousal trust, and the terms of the trust dictate that the shares must be distributed to the beneficiaries *in specie* upon the death of the surviving spouse, the shares obviously cannot be sold. If the shares cannot be redeemed, then it would not be possible to offset the capital gains realized in the trust upon the surviving spouse's death by triggering dividends and capital losses for tax purposes.

Where there is no provision that the freeze shares must be distributed to the residuary beneficiaries, it is possible to reduce double tax by instituting an annual retraction policy. The retraction will typically attract taxable dividends but the shares will no longer be available for a deemed disposition on the spouse's death. Should the estate trustee retract the shares to obtain income-producing property for the surviving spouse or should the trust hold on to the shares for the next generation? The answer, of course, will depend on each scenario's specific facts. If the second course of action is decided upon, it may be wise to get a waiver from the spouse.

Stop-Loss Provisions

The purpose of subsection 164(6) is to avoid double taxation on death; it is considered unfair to pay capital gains tax on deemed dispositions on death, and then again in respect of the same value on taxable dividends. However, in circumstances where the dividend is received tax-free, the application of loss rules may lead to an unintended extended deferral. To address this situation, certain stop-loss provisions, which apply to trusts and individuals receiving tax free dividends, were introduced in 1995.

i) Subsection 112(3.2)

This stop-loss provision reduces the capital loss incurred by an estate after April 26, 1995 based on a formula; its purpose is to limit the amount of loss that can be claimed where a tax-free capital dividend has been paid. Generally, the capital loss available to be carried back to the deceased taxpayer's final return is reduced to the extent more than 50% of the loss arose as a result of a dividend out of the capital dividend account. Life insurance proceeds fund this account to the extent the proceeds do not represent an investment gain.

Grandfathering (exemption) provisions relating to capital dividends are available, as in many cases planning had already been implemented and the use of the capital dividend account was integral to the overall distribution plan. The new provisions accommodated these already active plans, stipulating that the new stop-loss rules will not apply to a disposition of shares that occurs after April 26, 1995, in certain circumstances were life insurance was then in place. In order to qualify, the disposition of shares is made to the corporation that issued the shares and a corporate-owned life insurance policy must have existed for the purpose of funding a redemption or cancellation of shares.

ii) Subsection 40(3.6)

It is important to be aware of this subsection, as its provisions are far-reaching in their application to typical post mortem planning. Basically, it denies the immediate use of losses to a shareholder who remains affiliated with the corporation after the transaction that generated the loss. For example, often an estate freeze will involve a parent retaining the voting control of a corporation, while the non-voting growth shares are issued to members of a succeeding generation, or a trust, on their behalf. When the parent dies, the freeze and voting shares are transferred to the estate, resulting in the estate having control over the corporation. If the estate trustee receives the shares pursuant to a deemed disposition, and then wishes to retract the freeze shares to take advantage of subsection 164(6), the estate is denied use of the loss generated on the repurchase of the freeze shares; instead, the amount of denied capital loss is added to the cost base of the voting shares. Subsection 40(3.6) will not allow the estate to use the loss because the estate continues to own the controlling shares of the corporation, and thereby remains affiliated with the corporation. Another example is where the freeze shares are voting and only a partial retraction is undertaken.

One solution to these problems would be for the estate trustee to ensure, before the repurchase, that the corporation's share structure isolates the voting rights from the freeze shares. If the dispositive provisions of the will permit it, voting shares could then be distributed to a beneficiary or a trust where the majority of trustees do not cause the estate trustees to be affiliated with the corporation. The estate's freeze shares could then be partially or fully redeemed, and as the voting control was sufficiently distant from the estate trustees, subsection 40(3.6) would not apply. However, consideration must be given as to whether the CCRA could apply GAAR[10] in particular situations.

Another possible solution is for the estate trustee to cause the estate to transfer its freeze shares to a new holding corporation owned by the estate in exchange for shares of the holding corporation. The freeze shares could then be redeemed, giving rise to a tax-free inter-corporate dividend in the holding corporation . The holding corporation would then be wound up, and since the estate will be the sole shareholder of the holding corporation , subsection 69(5) would deem subsection 40(3.6) not to apply. Again, the CCRA might try to apply GAAR, but recent rulings have indicated this would not be likely.

Section 251.1 provides various definitions of affiliated persons, and these include an individual and his or her spouse, a corporation and a person who controls the corporation, a corporation and the spouse of the individual who controls the corporation, and a corporation and each member of the affiliated group that controls the corporation. Notably, siblings are not affiliated.

The Paragraph 88(1)(d) Bump

The paragraph 88(1)(d) bump procedure does not impact a taxpayer's deemed disposition on death. When successful, it reduces future tax on corporate pregnant gains having regard to the personal gains already taxed on death. Its primary mechanism is to enable the cost base of

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10 Document Number 1999-0010805, February 21, 2000

certain non-depreciable capital properties[11] of a corporation to be bumped so that such properties can be distributed to a shareholder estate without adverse tax consequences to either the corporation or the estate. It tends to have limited application in practice.

Using paragraph 88(1)(d) results in the cost base of the capital assets of an old holding corporation or operating corporation ("Oldco") being increased, when the Oldco winds up into a new holding corporation ("Newco"), to a value not exceeding the fair market value of the shares when control was last required of the corporation. Thus, although a capital gain is recognized in the taxpayer's final return, double taxation is avoided, as the previously accrued capital gain is not taxed when the Newco sells those assets.

This method of estate planning involves selling the shares owned by the estate to Newco, perhaps owned by the beneficiaries of the estate. Once Oldco is wound up, the underlying capital assets receive an increase in their adjusted cost base up to the fair market value of the assets at the time of death. If fully utilized, there is no double taxation and Newco is continued. The amount of the bump will need to be designated by Newco in its return for the taxation year in which Oldco is wound up. There are numerous qualifications applicable to a successful bump which are beyond the scope of this paper.

The paragraph 88(1)(d) bump can be combined with the application of the subsection 164(6) provisions. For example, if the bump would only be partial, the estate can repurchase a portion of the shares sold to the new holding corporation, which will generate a capital loss that can be carried back to the taxpayer's final return.

Pipeline Procedure

This procedure may be used to avoid the double tax effect in estates that hold shares with low paid-up capital in corporations that already have high cost base properties such as cash and treasury bills. It involves a reorganization which takes advantage of the high cost base of shares

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[11] The bump only applies to non-depreciable capital property that is not ineligible property. Ineligible property includes depreciable property and certain other property that is subject to the anti-avoidance provisions in that definition.

held by the estate resulting from the tax paid on death. It gives the estate a pipeline to allow access to the corporation's assets, usually on a tax-free basis. The pipeline procedure is similar to the paragraph 88(1)(d) bump procedure, except there is no technical need for the new holding corporation to wind up the old one or to make a paragraph 88(1)(d) designation, since the cost base of the property already approximates its fair market value. Consequently, Oldco can generally distribute the properties to Newco by inter-corporate dividends or deemed dividends without triggering any corporate level taxes in either corporation .

Post Mortem Planning

It should be noted that the pipeline procedure and the paragraph 88(1)(d) procedure will only be available in respect of certain types of assets and may not result in efficient use of surplus accounts. As a result, the two procedures may be of limited assistance in certain situations. The subsection 164(6) procedure, the paragraph 88(1)(d) procedure and the pipeline procedure are not mutually exclusive, so the implementation of one does not necessarily preclude the implementation of another.

To maximize an estate trustee's future flexibility, wills should provide authorizations that facilitate planning. Helpful powers would include the ability to seek tax advice, the power to sell, call in, exchange and convert any of the estate's assets into other assets, and the broad ability to exercise voting rights held by the estate. The estate trustee should be allowed to incorporate, restructure, wind-up or sell companies owned by the estate. The estate trustee should also have the ability to make elections under the *ITA*. Lastly, if a subsection164(6) plan is contemplated, the will should not mandate the distribution of relevant shares.