# POST-MORTEM STRATEGIES TO REDUCE TAX ON DEATH

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for

The Law Society of Upper Canada

8th Annual

Estates and Trusts Forum

November 30th, 2005

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# POST-MORTEM STRATEGIES TO REDUCE TAX ON DEATH[1]

## Introduction

Deemed dispositions on death for tax purposes set in motion a scenario that can result in double taxation. There are, however, a number of possibilities in the estate planning and administration context that can reduce the exposure to double taxation. 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. Below I discuss strategies that can reduce or even eliminate taxes at the corporate and/or estate level.

## 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 those assets[3]. The person who acquires the property because 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. As well, 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. It permits an election by a deceased taxpayer's personal representative to treat certain capital losses or terminal losses of the deceased's estate for its taxation year as capital losses or terminal losses of the deceased taxpayer in the year of death. Paragraphs 164(6)(a) and (c) allow the representative to elect to treat all or part of the capital losses of the estate as capital losses of the taxpayer from the disposition of the properties by the taxpayer in the taxpayer's last taxation year. Paragraph 164(6)(b) and (d) allow

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1 The author would like to acknowledge the valuable assistance received from Amanda J. Stacey of the Toronto office of Miller Thomson LLP.

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 representative to elect with respect to any terminal losses from the disposition of depreciable property of a prescribed class. These losses can only be used in the deceased's year of death; they cannot be carried back to years preceding 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. During this period, in the absence of a rollover, any corporate shareholdings held by the estate have an adjusted cost base equal to fair market value immediately before the taxpayer's death. If the taxpayer owned, for example, shares of a closely held Canadian-controlled private corporation (a "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 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 carry back does have some strict restrictions. For example, the three year carry back 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 realized 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 realization of a loss on the disposition of shares in the course of a 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 resolution of final tax matters, such as the final refund of the refundable dividend tax account. The CRA 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 can be a helpful indicator.

An estate trustee must make an election in order to be eligible to carry back the estate's capital losses to offset any gains 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, pursuant to 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 CRA 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 worth noting that to use the provision, the property in question must have passed to the *estate* of the deceased taxpayer, rather than to 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

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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.

definition applied beginning in the 2001 taxation year, and taxpayers who would have qualified 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 a capital gain. 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 incur any capital gains until he or she disposes of the assets. Section 73 of the *ITA* allows for the possibility of joint spousal trusts and alter ego trusts, which can 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 have been 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 other than the settlor and his or her spouse can be entitled to the capital of the trust before either of their deaths.

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

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* 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 prematurely. In the case of testamentary trusts, within thirty-six months after the death of the taxpayer (or a longer period where it may be reasonable in the circumstances), the property must vest in the spouse or spousal trust. Arguably, the wait for a tax clearance certificate can 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 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 provided for 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 available to individuals.

**iii) Qualifying Trusts - Generally**

The provisions of subsection 164(6) are not applicable to 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 gains, and the possibility for double taxation arises again. The question is whether any subsequent capital losses on the assets can be off set by 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 has ended, and in 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 CRA 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 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

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

9 Document Number 9714075, August 11, 1997

advantage of the net capital loss carryback provisions of paragraph 111(1)(a) of the *ITA*. 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 provision in the *ITA* allowing for capital losses realized by the residuary beneficiaries to be applied against capital gains realized in a spousal trust because of the surviving spouse's death. Similarly any 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 taxation 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. The question is whether the estate trustee should retract the shares to obtain income-producing property for the surviving spouse or whether the trust should hold the shares for the next generation. The answer, of course, will depend on each scenario's facts. If the second course of action is decided upon, it may be wise to obtain 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 that 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) Subsections 40(3.4), (3.6) and new subsection 40(3.61)**

Subsection 40(3.4) applies if a corporation, partnership or trust transfers capital property to an affiliated person. Subsection 40(3.6) applies if a taxpayer transfers shares that are capital property of a corporation to a corporation that is affiliated with the taxpayer immediately after disposition. New subsection 40(3.61) exempts the portion of an estate's capital loss carried back pursuant to subsection 164(6) from the application of subsections 40(3.4) and (3.6). This new subsection applies in respect of dispositions made after March 22nd, 2004.

The rules in subsection 40(3.4) and (3.6) defer a taxpayer's loss on a disposition of property where the property remains within an affiliated group of persons. Recent amendments to subsection 251.1(1) of the *ITA* could in some cases cause these loss deferral rules to apply to an estate. The following examples are illustrative: under the new rules in subsection 251.1(1), an individual who is the majority interest beneficiary of the estate of deceased taxpayer will be affiliated with the estate, as would a corporation controlled by the that individual. As a result, a loss arising from a redemption by the corporation of shares held by the estate would be deemed to be nil by subsection 40(3.6). The loss carry back permitted by subsection 164(6) of the *ITA* would also be caught by the rules in subsections 40(3.4) and (3.6).

Proposed subsection 40(3.61) provides an important exception to the application of subsections 40(3.4) and (3.6) to the estate loss carry back rules under subsection 164(6). It provides that if, in the course of administering the estate of a deceased taxpayer, the taxpayer's legal representative elects in accordance with subsection 164(6) to treat all or a portion of the estate's capital loss from the disposition of a share of the capital stock of a corporation as a capital loss of the deceased taxpayer from the disposition of that share, subsections 40(3.4) and (3.6) apply to the estate in respect of the loss only to the extent that the amount of the loss exceeds the portion of the loss to which the election applies. In other words, if the loss carried back is in excess of the election allowed by subsection 164(6), the excess will be subject to subsections 40(3.4) and (3.6) and the deceased taxpayer will be denied the loss.

Section 251.1 provides various definitions of affiliated persons, including 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. Recent amendments to this section deal specifically with trusts. New paragraphs 251.1(1)(g) and (h), in tandem with new definitions for "beneficiary", "contributor", "majority interest beneficiary" and "majority interest group of beneficiaries" in subsection 251.1(3), and new interpreting rules in subparagraphs 251.1(4)(c)(i) to (v) expand the existing affiliated persons rules to expressly apply to trusts. After March 22nd, 2004, a trust will be affiliated with any beneficiary who has a majority interest in the trust. Further, two trusts will be affiliated if the following conditions are met:

- A person who has contributed property to one of the trusts on a non-arm's length basis or for inadequate consideration is affiliated with any such person in respect of the other trust.
- Beneficiaries that enjoy a majority of the income or capital of one of the trusts are affiliated.

In the case of discretionary trusts, in determining if the beneficiary has a majority interest, any discretion of any person in respect of the trust will be regarded as fully exercised (or not exercised, as the case may be) in respect of each person who is a potential beneficiary of the discretion. The practice of looking at a trustee's relationships in determining whether a trust is affiliated has been eliminated by these new rules.

**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. The primary mechanism is to enable the cost base of certain non-depreciable capital properties[10] of a corporation to be bumped so that such properties can be distributed to a shareholder's 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 an increase in the cost base of the capital assets of an old holding corporation or operating corporation ("Oldco") when Oldco winds up into a new holding corporation ("Newco"), up to a value not exceeding the fair market value of the shares when control was last acquired. Thus, although a capital gain is recognized in the taxpayer's final return, double taxation is avoided, as the previously accrued capital gains are not taxed when Newco sells those assets.

This method of estate planning involves selling the shares owned by the estate to Newco, which in turn can be 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.

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[10] 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.

**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 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 subsection 164(6) plan is contemplated, the will should not mandate the distribution of relevant shares.