

Death / Taxes & Post-Mortem Tax Planning

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Calculating Income on Death

- **Periodic payments** – accrue to date of death (ie, rent).
- **Rights or things** – Example – declared but unpaid dividend.
 - Can file a separate return or transfer to a beneficiary.
- **RRSP / RRIF** – FMV income inclusion is deemed received.
 - Effectively, the income inclusion can be transferred on a tax-deferred basis to a spouse or dependent child / grandchild.
- **TFSA** - Deemed disposition and reacquisition.
 - Loses tax-exempt status unless transferred to a spouse.
- **Capital property** – Deemed disposition and reacquisition at FMV.
 - Most post-mortem planning we deal with involves private company shares.

Issues to Consider on Death

- **Liquidity**
 - How will tax be paid? Insurance? Sale? Bank financing?
- **Double / Triple Tax**
 - Likely will be additional tax when corporately owned assets are sold and funds are paid to shareholders.
- **Tax Deferral vs. Asset Protection**
 - Often want to maximize the tax deferral by transferring to spouse or spousal trust.
 - Also want to ensure sufficient wealth passes to children.
 - May have children from another marriage to consider.
- **Tax Paid Cost Base**
 - Beneficiary (other than spouse) / Estate will inherit the property with high ACB.
 - Essentially, post-mortem planning is used to access tax paid cost base on death.

Double / Triple Taxation on Death

Why?

- Double taxation arises whenever assets with an accrued gain are held in a separate vehicle (eg, corporation, partnership).
- Gain on deemed disposition of shares, then gain on sale of asset.
- Potentially, third layer of tax when sale proceeds are paid out to shareholders.

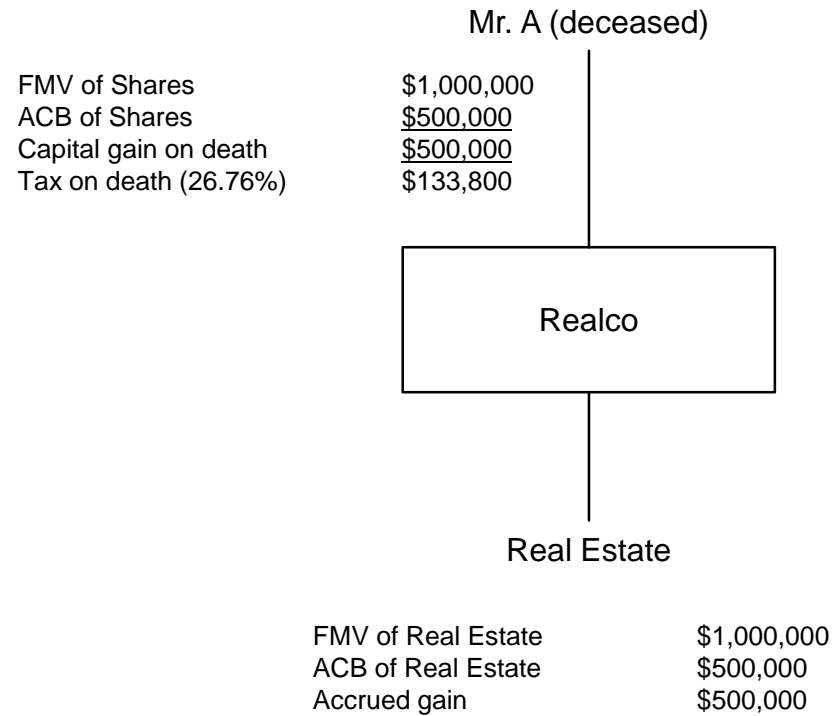
Double / Triple Taxation on Death

Corporate Owned Assets

- Deceased taxpayer deemed to realize accrued gain on shares at death.
- Estate acquires shares at fair market value (“FMV”) with adjusted cost base (“ACB”) equal to FMV.
- No ACB bump on death of assets owned by corporation.
- Future sale of corporate assets results in capital gain taxable in the corporation, with no relief for tax previously paid by deceased taxpayer, therefore double taxation.
- A further layer of tax is paid when the funds are paid out to the shareholders, resulting in triple taxation (subject to potential PUC, CDA, loan balances).

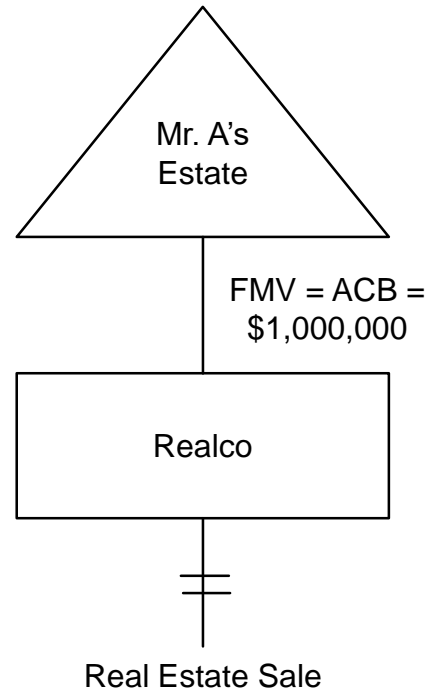
Double / Triple Taxation on Death

1st Layer of Tax



Double / Triple Taxation on Death

2nd Layer of Tax on Sale of Real Estate

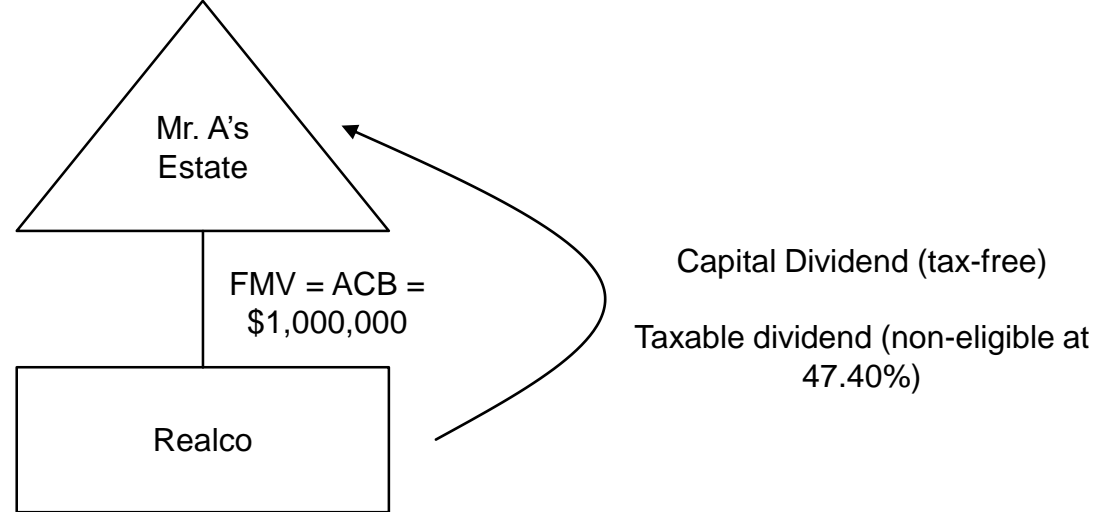


FMV of Real Estate	\$1,000,000
ACB of Real Estate	<u>\$500,000</u>
Capital Gain	<u>\$500,000</u>
Tax 26.76%	\$133,800

(assumes no recapture)

Double / Triple Taxation on Death

3rd Layer of Tax on Distribution of Corporate Funds to Shareholders



Tax on share disposition = \$133,800
Tax on real estate disposition = \$133,800
Tax on dividend = \$173,579

New Testamentary Trust Rules

Changes Effective for the 2016 Taxation Year

- Draft legislation released on August 29, 2014.
- Bill C-43 received Royal Assent on December 16, 2014.
- Repeal of subsection 122(2) and amendment of subsection 122(1) result in the elimination of graduated rates for testamentary trusts (including estates) and grandfathered *inter vivos* trusts (created before June 18, 1971).
- Exceptions are made for Graduated Rate Estates (“GRE”) as defined in subsection 248(1) and Qualified Disability Trusts (“QDT”) as defined in subsection 122(3).
- New subsection 104(13.4) provides that gains and losses arising on deemed dispositions of trust property upon death of a life interest beneficiary are now included in the terminal return of the life interest beneficiary (rather than being taxed in the trust).

New Testamentary Trust Rules

Changes Effective for the 2016 Taxation Year

Conditions for GRE:

- Arose no more than 36 months after death of taxpayer;
- Estate is at that time a testamentary trust (defined in subsection 248(1));
- The individual's social insurance number is provided in the Estate's return;
- The Estate designates itself as a GRE of the individual for the first taxation year that ends after 2015; and
- No other Estate designates itself as the GRE of that individual in a return of income for a taxation year that ends after 2015.

New Testamentary Trust Rules

Benefits of a GRE

- Graduated rates.
- Exemption from tax instalments.
- Year-end can be off calendar year-end.
- Ability to elect under subsection 164(6) (discussed later).
- Ability to carry-back charitable gifts made within 60 months to the prior year of the Estate, the terminal return, or the deceased's last return for the year before death.
- Taxable capital gain on charitable gift of Pubco shares is deemed nil.

New Testamentary Trust Rules

Conditions for a QDT:

- A trust that at the end of the trust's year is a **testamentary trust** (includes insurance trusts) that arose on and as a consequence of death;
- Is factually resident in Canada for the trust's year;
- Includes in its T3 return for the year an election made **jointly with one or more** beneficiaries under the trust in the prescribed form to be a QDT for the year and includes the social insurance number of each of its electing beneficiaries (there is no relief for a late election and, if incapable, an electing beneficiary may need a legal guardian to make the election); and
- All electing beneficiaries are individuals named in the instrument (ie, the Will) by which the trust was created as a beneficiary under the trust in respect of whom paragraph 118.3(1)(a) (ie, disability tax credit) applies for the individual's taxation year in which the trust year ends.

New Testamentary Trust Rules

Donations

- If donor is the deceased's GRE, then donation credits can be used by the GRE on the deceased's terminal return or return for a prior year (can be carried forward 5 years by GRE).
- Donations must be made within 36 months of the GRE.
- Donated property must be property that was received by the Estate on death "or is property that was substituted for that property."

Spousal Trusts

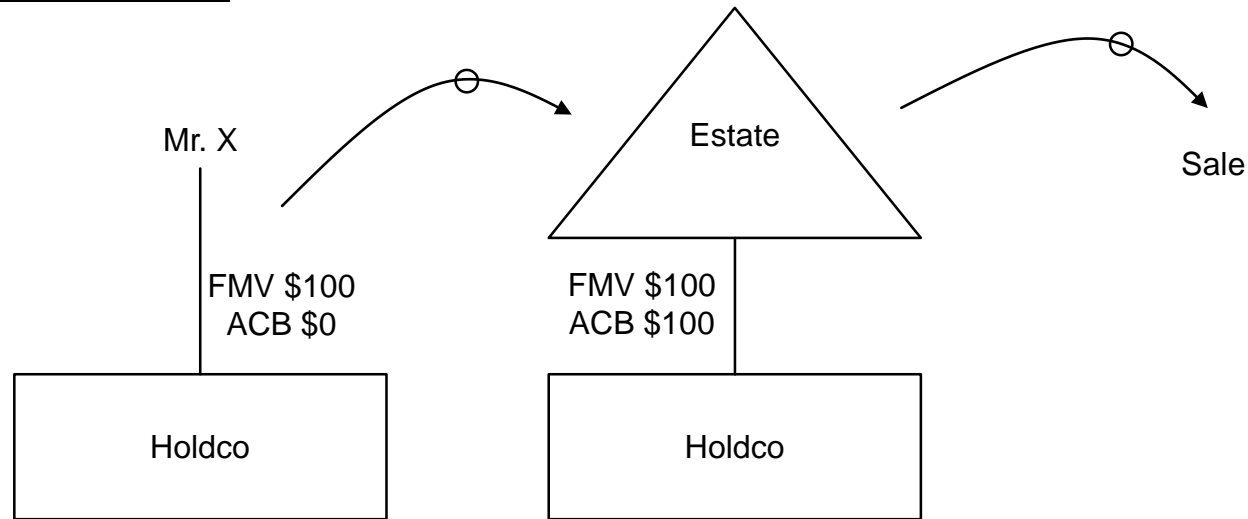
- Can be *inter vivos* or testamentary.
- Capital property can be “rolled in” to a spousal trust tax-free (note that the rollover only applies to property owned on death). No substituted property rule.
- To qualify spouse of the deceased settlor must be entitled to all income during their lifetime and no other person can receive income or capital during their lifetime (note that the payment of life insurance premiums can taint the trust since capital is being used to fund a life insurance beneficiary other than the spouse).
- Trust is deemed to dispose of assets on death of spouse—no 21-year rule.

Post-Mortem Planning

- Different methods of minimizing / eliminating additional tax after death where deceased owned shares:
 1. Sell corporate shares not the underlying assets.
 2. 164(6) loss carry-back election.
 3. Use capital losses against capital gains.
 4. Use of high ACB (pipeline).
 5. Use of high ACB (88(1)(d) bump).

Post-Mortem Planning

Sell Shares Not Assets



- No double taxation where shares of the company are sold.
- Generally, not practical where company is an investment company.
- Practical only where company carries on an active business. However, purchaser may still prefer to buy assets not shares, so not always possible.
- Especially unfavourable in situations where there is real estate.

Post-Mortem Planning

164(6) Election

- Remember, on death a capital gain is realized on shares.
- If election is made net capital losses realized within first taxation year of the Estate are deemed to be capital losses of the deceased.

Conditions for election:

- Estate must be a GRE;
- Disposition of property occurs within first taxation year of the Estate;
- Election must be in prescribed manner and within prescribed time; and
- Estate must have overall capital loss.

Post-Mortem Planning

164(6) Election

Prescribed manner:

- Letter from legal representative specifying the amount of capital losses and / or terminal losses elected under 164(6);
- Schedule of capital losses / gains elected under subsection 164(4);
- Schedule showing terminal loss calculation.

Prescribed time:

- Documents referred to under “prescribed manner” due not later than the later of:
 - Due date of terminal return / elective returns; and
 - Due date of Estate’s tax return for its first taxation year.
- Note that the executors can apply to late file the election, however, the transaction resulting in the loss must occur within the first taxation year of the Estate.

Post-Mortem Planning

164(6) Election

Caution:

- Watch for short taxation years of the Estate:
 - Capital losses must be realized within the first taxation year of the Estate not 12 months.
- Capital losses under this election can only carry back to the deceased's terminal return and not the year preceding death.
- Since an estate that qualifies as a GRE can adopt a year-end of its choice, a short taxation year will shorten the timeframe in which these capital losses need to be realized. For example, if an individual died in November and the executors determine that the first year of the Estate should end on December 31, then the capital losses would have to be realized by December 31. There is no provision for capital losses realized after the first year of the Estate to benefit from this election, even if the losses are realized within a 12-month period.

Post-Mortem Planning

164(6) Election

What if:

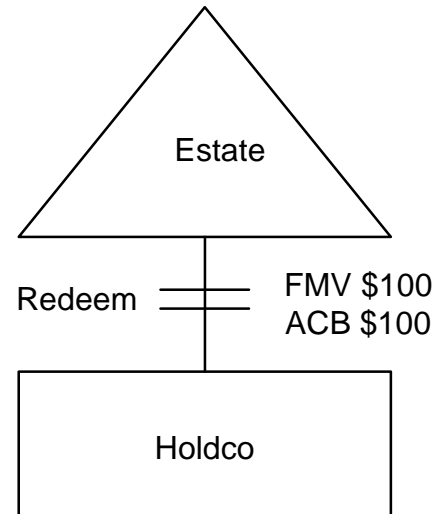
- Estate doesn't have capital losses?
- Can we create capital losses? Yes.
- Where shares of a company owned by Estate are redeemed.
 - Capital loss on redemption of shares used to offset deemed capital gain on shares reported on the terminal return.

Post-Mortem Planning

164(6) Election

Results:

- Net effect of 164(6) election is that tax is paid by Estate on dividend.
- Effective strategy where corporation has CDA / RDTOH.
- Life insurance can be used to create CDA (subject to 50% solution).



Proceeds:	\$100
PUC:	\$0
Deemed dividend:	\$100
Adjusted Proceeds:	\$0
ACB:	\$100
Capital loss:	\$100

Post-Mortem Planning

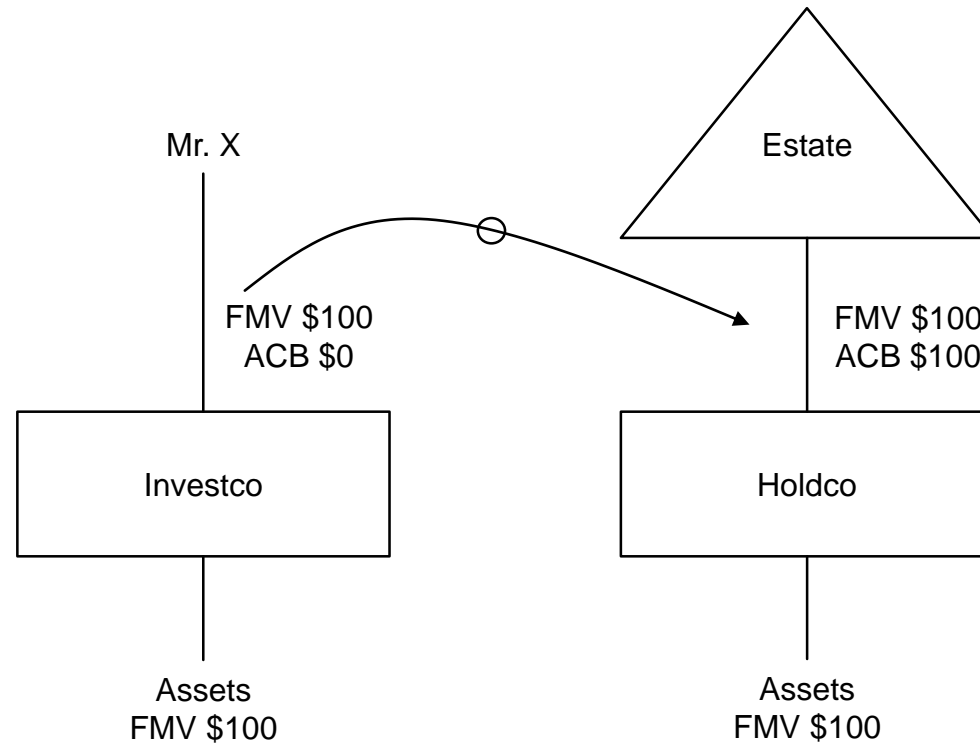
164(6) Election

Interplay of Stop-Loss Rules and Post-Mortem Planning

- Subsection 40(3.6) – denies loss on redemption where taxpayer is affiliated with corporation.
- 40(3.61) provides that 40(3.6) won't apply if 164(6) election is made.
- Subsection 112(3.2) – applies to reduce loss by amount of capital dividend where capital dividend exceeds 50% of loss or gain on death → leads to 50% solution.
- Result is that the deceased cannot eliminate 100 percent of tax using CDA.

Post-Mortem Planning

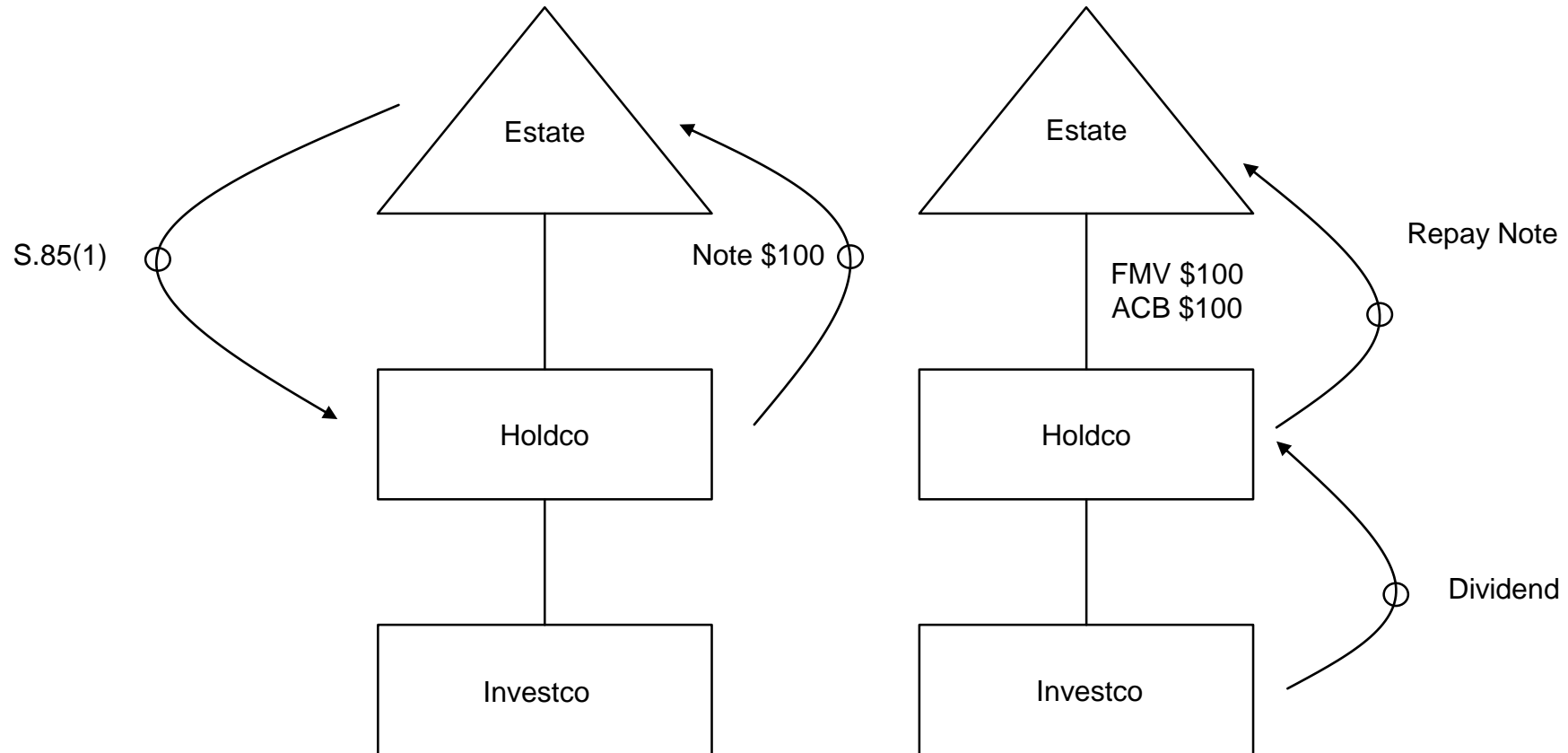
Use of ACB - Pipeline



ACB of shares increases to \$100

Post-Mortem Planning

Use of ACB - Pipeline



Post-Mortem Planning

Use of ACB - Pipeline

- The Estate will transfer its shares, pursuant to subsection 85(1) of the Act, to a holding company. On the transfer, the Estate will take back a promissory note, equal to the ACB of the shares, and one common share of the holding company.
- Investco could then pay a dividend (or loan) up to Holdco, which is received tax-free by Holdco, and Holdco could use proceeds from the dividend to repay the note to the Estate.
- This is the pipeline method. CRA has said that they may try to deem the note to be a dividend under subsection 84(2). Note CRA has favourable views regarding subsection 55(2) in these circumstances.
- CRA has three criteria which must be met to avoid the application of 84(2):
 1. The transferee corporation (Investco) and Holdco must remain separate and distinct for one year from the date the shares were transferred to Holdco.
 2. The transferee corporation (Investco) must continue to carry on business in the same manner as before for at least one year.
 3. Following the one-year period in 2 above, the promissory note can be gradually repaid over time (2 to 5 years). Note, in recent CRA commentary, the CRA has provided that it will accept notes being repaid in one year after the one-year period in 2. above.

Post-Mortem Planning

Use of ACB - Pipeline

Result:

- Net effect of pipeline strategy is capital gains tax paid by deceased on death at 26.76%.
- May still be tax in corporation when assets liquidated (may lead to SBD grind under AAI).
- Adhering to CRA position, repayment of note can take time (ie, 2 to 5 years).

Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

- Not required to be done within first year of death.
- Avoids double taxation for non-depreciable capital property by increasing the cost base of corporate property up to FMV at date of death.
- An 88(1)(d) bump is an alternative to subsection 164(6) planning. The 88(1)(d) bump planning has an advantage over 164(6) in that there is no time limit within which this planning is to be made. However, this planning is only available where the company owns non-depreciable capital property.

Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

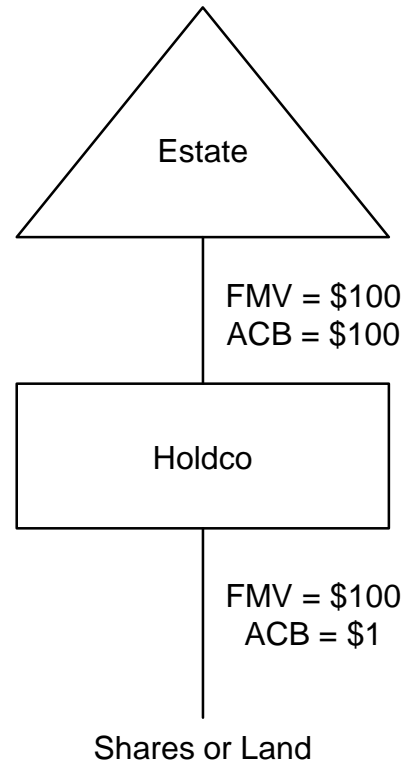
When to use:

- Applies only to non-depreciable capital property:
 - Land (not building)
 - Shares
 - Partnership interest
- Not generally useful for operating companies, investment real estate companies (cannot step-up building portion) or land inventory.

Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

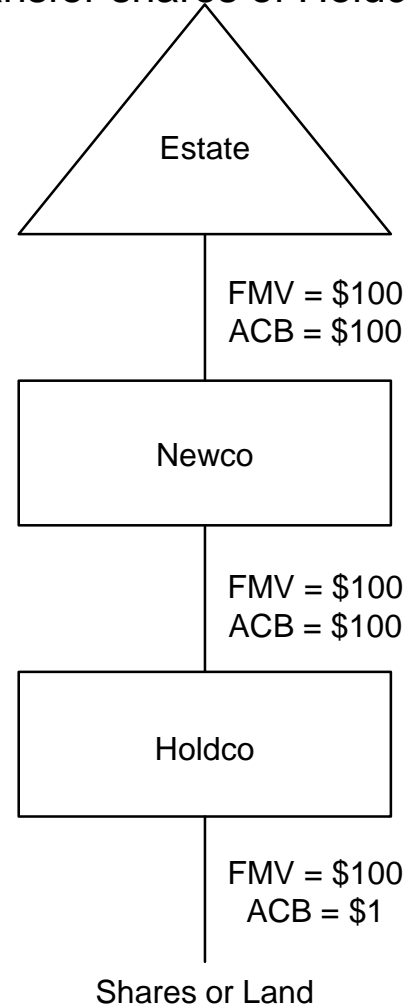
Initial Structure



Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

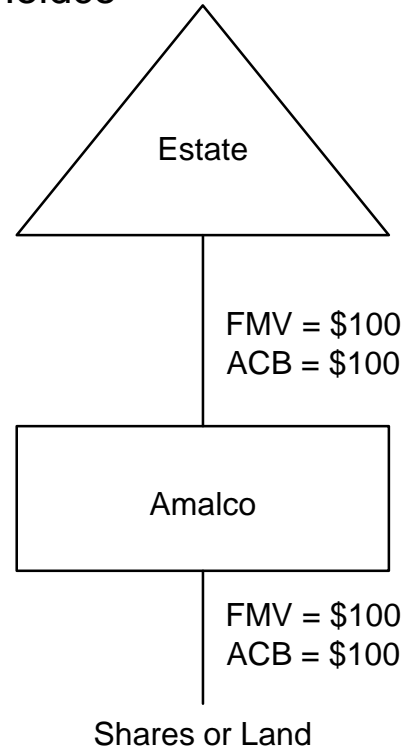
Must incorporate new company and transfer shares of Holdco for shares of Newco.



Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

Amalgamated or Wind-up Newco and Holdco



Step up cost base of shares / land to date of death value.

Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

Issues to consider:

- Type of assets owned by Holdco.
- Timing of sale of assets.
- Different needs of beneficiaries.
- Timing of amalgamation or wind-up.
- Extraction of funds (consider combining strategy with a pipeline).
- Only applies to property in Holdco at time of death.
- More complicated with many shareholders or tiered holdco structure.

Post-Mortem Planning

Use of ACB - 88(1)(d) Bump

Result:

- May be able to reduce or eliminate tax in corporation on liquidation of assets.
- If used with pipeline then proceeds from sale can be paid out tax-free to Estate via promissory note.
- Net effect is capital gain paid by deceased and little to no tax in corporation.

Impact of TOSI

- “Specified Individual” excludes a trust and since GRE’s are trusts, the TOSI rules should not apply to 164(6) planning (however, income allocated to beneficiaries of the GRE could be caught).
- TOSI does not apply to deemed capital gains on death under 70(5).
- Pipeline and bump planning should not result in “split income” and therefore TOSI should not apply.
- There are specific exceptions from TOSI for inherited property. For example, if <24 property inherited on death of parent is excluded.
- Specific deeming rules can apply to persons age 18 or older that permit the person to inherit the contributions made by the deceased. For example, if deceased was active for >5 years, this trait will pass on to the beneficiary.

Plan Ahead - What to Watch For

- Date of death (1-year rule for 164(6) and 3-year rule for GRE).
- Wording in Shareholders' Agreements (is there a buyout? How does it work?).
- Wording in Wills (dual Wills? No Wills? Spousal trust?).
- Insurance opportunities (liquidity issues? Under funded buy-sell surplus investment income?).
- RDTOH and CDA balances (can be used for 164(6) planning).
- Non-depreciable capital assets (can be bumped).