LEGAL BUSINESS REPORT ALPERT LAW FIRM
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POST-MORTEM TAX PLANNING

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on post-mortem tax planning for small businesses and their shareholders.

Alpert Law Firm is experienced in providing legal services to its clients relating to estate planning, including the preparation of wills, deeds of gift, trust documents and all documentation required in connection with estate freezes and other tax, corporate and estate planning matters.

A. DOUBLE TAXATION ON DEATH

Pursuant to subsection 70(5) of the Income Tax Act (the "Act"), a deceased taxpayer is deemed to dispose of all of his or her property immediately before death at fair market value and to realize all accrued capital gains and losses, and the deceased taxpayer's estate is deemed to have acquired the property at a cost equal to the fair market value. For a deceased taxpayer who owns shares of a private corporation, taxable deemed dividends may also be triggered pursuant to subsection 84(2) of the Act if the corporation is subsequently wound up or liquidated. The deemed dividend is the amount by which the proceeds paid to the shareholders on the winding-up of the corporation exceeds the paid-up capital of the shares.

Consequently, the increase in value of the corporation may be taxed twice: first as a capital gain as a result of the deemed disposition rules at the time of death, and second as a deemed dividend as a result of the distribution of corporate assets to the deceased's estate upon wind-up. Various post-mortem tax planning strategies, such as subsection 164(6) loss carryback elections and pipeline plans, can be implemented to eliminate double taxation on death.

B. SUBSECTION 164(6) LOSS CARRYBACK ELECTION

Subsection 164(6) of the Act allows the executor of an estate to carry back the capital losses realized by the estate in its first year to the terminal return of the deceased taxpayer ("164(6) loss carryback election"). The 164(6) loss carryback election will offset any capital gain realized by the deceased taxpayer as a result of the deemed disposition of shares on death and eliminate or reduce the problem of double

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taxation on death. Generally, the steps for making a 164(6) loss carryback election are as follows:

(i) the corporation reduces the fair market value of the shares to a value below their adjusted cost base ("ACB") by issuing dividends or by triggering deemed dividends to the estate;

(ii) the estate then realizes a capital loss when it disposes of or redeems the deceased's shares; and

(iii) the estate makes a subsection 164(6) election to have the capital loss designated as a loss realized by the deceased on his or her terminal return. As a result, the shares are only taxed once at the dividend tax rate.

A 164(6) loss carryback election is only available where the estate is a "graduated rate estate" ("GRE"). A GRE is defined as an estate that arose on and as a consequence of the individual's death if that time is no more than 36 months after the death of the individual, and the estate is at that time a testamentary trust that meets the following conditions:

(i) the estate designates itself as the deceased individual's GRE by filing a T3 return for its first taxation year;

(ii) no other estate designates itself as the GRE of the deceased individual. If an individual has multiple wills, only one estate may be designated as a GRE; and

(iii) the deceased individual's social insurance number must be provided in the estate's T3 return for each taxation year of the estate during the 36-month period after the death of the individual.

To make the 164(6) loss carryback election, the executor must attach the following documents to the estate's T3 return for its first taxation year:

(i) A letter indicating that the estate is making an election under subsection 164(6) and providing the amount of the capital loss elected to be a capital loss of the deceased person; and

(ii) A schedule with details of the capital loss.

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The executor is then required to file an amended terminal return for the deceased taxpayer to reflect the elected capital losses.

For 2016 and subsequent years, a GRE may choose to have a non-calendar tax year. A GRE seeking to make the 164(6) loss carryback election should choose the date of the taxpayer's death as its tax year-end in order to maximize the timing window in which the election can be made. Since the election must be made in the estate's T3 return for its first taxation year, the deadline to make the election is generally one year plus 90 days following the taxpayer's death if the GRE chooses the date of the taxpayer's death as its tax year-end.

If the estate misses the timing window for making a 164(6) loss carryback election, it can consider implementing a post-mortem pipeline plan, which is explained in detail in the following section.

C. PIPELINE PLANS

A pipeline plan is a strategy implemented by the deceased's estate to avoid double taxation on death. The implementation of a pipeline plan ensures that the increase in value of the corporation is only taxed once as a capital gain to the deceased taxpayer in the year of death. Implementing a pipeline plan generally involves the following steps:

(i) The estate incorporates a holding corporation and transfers the deceased's private corporation shares to the holding corporation in consideration for a promissory note equal to the fair market value of the transferred shares;

(ii) The private corporation subsequently amalgamates with or winds-up into the holding corporation, and all of the private corporation's assets are transferred to the holding corporation; and

(iii) The holding corporation uses the assets received on the wind-up of the private corporation to repay the promissory note held by the estate on a tax-free basis. The estate receives the retained earnings of the corporation without any additional tax liabilities.

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There is some concern that subsection 84(2) of the Act may apply to treat the promissory note as a deemed dividend. Generally, under subsection 84(2) of the Act, a corporation is deemed to have paid a dividend where funds or property of the corporation have been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of the shareholders, on the winding-up, discontinuance or reorganization of its business. The application of subsection 84(2) to a pipeline plan would negate its tax benefits. However, for many years, Canada Revenue Agency (the "CRA") issued favourable advance rulings on pipeline plans and opined that subsection 84(2) would not apply to these proposed transactions, particularly in the following circumstances:

(i) the private corporation continues to carry on its business in the same manner as before following its shares being transferred to the holding corporation;

(ii) the private corporation does not amalgamate with or wind-up into the holding corporation for at least one year following the initial implementation of the pipeline structure; and

(iii) the holding corporation does not begin to repay the promissory note held by the estate for at least one year, and then gradually repays the amount over an additional period of time.

CRA has highlighted that determining whether subsection 84(2) applied to a particular pipeline plan required a full and thorough review of all facts and circumstances. In CRA's view, the existence of the following facts may warrant treating the promissory note as a deemed dividend:

(i) the private corporation ceases to carry on business activities following its shares being transferred to the holding corporation; and/or

(ii) the funds or property of the private corporation is distributed to the deceased's estate in a short time frame following the taxpayer's death;

D. PARAGRAPH 88(1)(d) AND SUBSECTION 87(11) BUMPS

If the assets held by a deceased taxpayer's corporation have appreciated considerably in value since their acquisition, a "bump" may be used to avoid or reduce double taxation on death. The paragraph 88(1)(d) bump permits a parent corporation to

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increase the ACB of non-depreciable capital property acquired from the subsidiary on a qualifying wind-up to the property's fair market value as of the date of the taxpayer's death. Similarly, the subsection 87(11) bump permits the amalgamated corporation to increase the ACB of non-depreciable capital property acquired from the predecessor corporation on an amalgamation to the property's fair market value as of the date of the taxpayer's death. The "bump" to the ACB of the assets results in reduced tax payable when these assets are disposed of by the corporation.

The "bump" strategy is often implemented together with the pipeline plan strategy. As mentioned above, in a pipeline plan, the shares of a private corporation owned by the deceased at the time of death are transferred to a holding corporation in exchange for a promissory note. The private corporation is then merged with the holding corporation by (i) a wind-up pursuant to subsection 88(1) of the Act; or (ii) an amalgamation pursuant to subsection 87(11) of the Act. During the winding up or amalgamation of the two corporations, the ACB of the non-depreciable capital property of the private corporation is bumped up to its fair market value at the time of the taxpayer's death. The assets can then be used to pay down the promissory note owing to the estate.

(i) Paragraph 88(1)(d) Corporate Wind-Up Bump

Section 88 of the Act sets out the general rules dealing with the winding-up and dissolution of a Canadian corporation. The requirements for a subsection 88(1) wind-up are the following:

(i) the parent corporation and subsidiary must both be taxable Canadian corporations;

(ii) the parent corporation must own at least 90% of the shares in each class of shares of the subsidiary; and

(iii) any other shares of the subsidiary must be owned by non-arm's length parties.

In a post-mortem subsection 88(1) wind-up transaction, the holding corporation becomes the parent corporation and the private corporation whose shares are owned by the deceased becomes the subsidiary. When the subsidiary is wound up into the parent corporation in a subsection 88(1) wind-up transaction, the parent corporation will be deemed to have acquired most of its subsidiary's non-depreciable capital properties at their cost amount for tax purposes. Where the parent corporation's ACB of the

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subsidiary's shares exceeds the ACB of the subsidiary's assets, the parent corporation may elect to bump up the ACB of certain non-depreciable capital property.

To implement a paragraph 88(1)(d) bump, the parent corporation must designate the amount of the bump in respect of each capital property to which the bump is applied in its tax return for the taxation year in which the subsidiary is wound up. For property to qualify for the paragraph 88(1)(d) bump, the property must be capital property of the subsidiary and the property must not be (i) depreciable property; (ii) transferred as part of a butterfly reorganization; or (iii) property that the subsidiary acquired from the parent corporation or from a person or partnership who dealt with the parent corporation on a non-arm's length basis.

In addition to the property eligibility requirements set out above, there are a number of other limitations to the paragraph 88(1)(d) bump strategy. First, the estate must have control of the private corporation that is being wound-up. If an estate freeze is implemented during the taxpayer's lifetime, the taxpayer (i.e. the freezor) should retain voting control of the freeze corporation to ensure that a paragraph 88(1)(d) bump is available to the estate upon his or her death. Second, the ACB of the property cannot be bumped to an amount higher than the fair market value of the property at the time the estate acquired the shares. Third, bumps are not permitted in combination with tax-free divisive butterfly reorganizations.

(ii) Subsection 87(11) Corporate Amalgamation Bump

Alternatively, the estate may choose to amalgamate the private corporation and the holding corporation instead. Section 87 of the Act sets out the rules dealing with amalgamations of two or more Canadian corporations. The requirements for a section 87 amalgamation are the following:

(i) the amalgamation must qualify as a merger of two or more taxable Canadian corporations to form one amalgamated corporation;

(ii) each of the predecessor corporations must have the same incorporating jurisdiction;

(iii) all of the assets and liabilities of each of the predecessor corporations must become the assets and liabilities of the amalgamated corporation, subject to certain exemptions; and

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(iv) all of the shareholders of the predecessor corporations immediately before the amalgamation must receive shares of the amalgamated corporation by virtue of the merger, with the exception of shares held by one predecessor corporation in another.

Pursuant to section 87 of the Act, a rollover of the assets of the predecessor corporations into the amalgamated corporation is automatically deemed to occur such that all assets, liabilities and various tax accounts of the predecessor corporations flow through to the amalgamated corporation on a tax-free basis.

The requirements and limitations for implementing a bump under subsection 87(11) are identical to the requirements and limitations set out above for a paragraph 88(1)(d) bump.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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APPENDIX A

EXAMPLE OF PARAGRAPH 88(1)(d) AND SUBSECTION 87(11) BUMP

FACTS:

1. Testator ("T") is the sole shareholder of Real Estate Co.

2. T died on January 1, 2018 and is deemed to have disposed the shares of Real Estate Co. having an ACB of $1, PUC of $1 and FMV of $600,000.

3. T's estate is deemed to have acquired the shares of Real Estate Co. from T at an ACB equal to the FMV of $600,000.

4. On January 1, 2018, Real Estate Co owns a real estate property with ACB of $200,000 and FMV of $600,000, allocated as follows:

   Land: ACB = $50,000; FMV = $300,000

   Building: ACB = $150,000; FMV = $300,000

5. T's Estate rolls the shares of Real Estate Co to Holdco on a tax-free basis pursuant to subsection 85(1) of the ITA. Holdco's ACB of the Real Estate Co shares is $600,000.

6. Real Estate Co. and Holdco subsequently amalgamate into Newco.

CALCULATION OF BUMP:

1. The amount of the bump is the lesser of:

   a) The amount by which the FMV of the eligible property at the time of death exceeds the ACB of the eligible property; and

   b) The amount by which the parent corporation's ACB of the subsidiary's shares exceeds the ACB of the subsidiary's assets.

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2. In this example, the bump to the ACB of the land is the lesser of:

   a) \$300,000 (FMV of land on date of death) - \$50,000 (ACB of land) = \$250,000; and

   b) \$600,000 (ACB of Real Estate Co shares) – \$200,000 (ACB of Real Estate Co assets) = \$400,000

3. Therefore, Newco can bump up the ACB of the land by \$250,000. After the bump, the ACB of the land is increased to \$300,000, which is the FMV of the land on the date of T's death.

   Note: only the ACB of the non-depreciable land can be bumped up. The ACB of the building cannot be bumped because the building is a depreciable property.