Death & Taxes

By Chad J. Brown

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Benjamin Franklin wrote in his November 13, 1789, letter to Jean-Baptiste Leroy "... in this world nothing can be said to be certain, except death and taxes." Those timeless words echo as true today as ever, and as such, all legal practitioners should understand some basics of estate income tax planning, as they will eventually find themselves providing preliminary advice to an estate or beneficiary. Even if you attempt to avoid estate administration like the grim reaper himself, I hope the following tips will help answer some basic client questions and assist you with issue identification. Of course, it is recommended that an experienced tax advisor be retained to avoid the many pitfalls associated with this complicated area, in particular where the deceased has significant property and business interests.

The Deemed Disposition

Subsection 70(5) of the *Income Tax Act* (the "Act") generally provides that a taxpayer who dies in a taxation year is deemed to have disposed of, immediately before his or her death, each property that was owned by the taxpayer immediately prior to his or her death for proceeds of disposition equal to the fair market value ("FMV") of such property at that time. Paragraph 70(5)(b) provides that a person who, as a consequence of the deceased taxpayer's death, has acquired any such property is deemed to have acquired it for a cost equal to its FMV immediately before death. Accordingly, all unrealized gains and losses on all property owned by the deceased taxpayer at the time of his or her death must be reported in the final T1 personal income tax return of the deceased (the "terminal return").

The properties deemed to be disposed of by the deceased taxpayer are notionally received by a testamentary trust of the deceased (the "Estate") for the purposes of administration.

(a) Spousal Rollover

By virtue of subsection 70(6), the deemed disposition referred to above does not apply to property transferred by an individual to the spouse or common-law partner of the individual as a consequence of the death of the individual. The deceased individual is deemed to have disposed of the asset at its "cost amount" and the surviving spouse or common-law partner is deemed to have acquired it at the same "cost amount". Therefore, no gain or loss should be realized by the estate of the deceased individual for these types of transfers.

(b) The 164(6) Election

Subsection 164(6) permits a deceased taxpayer's legal representative to elect to report certain losses realized in the first taxation year of the Estate on the terminal return. 164(6) can be used to carry losses of the Estate back to the terminal return of the deceased to offset gains reported on the terminal return of the deceased individual, including gains deemed pursuant to subsection 70(5).

If this provision did not exist, an Estate which realized losses on the disposition of property in its first taxation year might not ever have an opportunity to use these losses since the Estate might not ever realize in the future any gains or other income to offset against these losses.

It is important to note that only losses realized during Estate's first taxation year can be carried back to the terminal return. Any losses realized by the Estate in a subsequent taxation year cannot be carried back to the terminal return. As such, planning for the disposition of any property that is "underwater" (i.e. FMV less than the tax cost) during the first year is paramount.

(c) The Pipeline Strategy

The Pipeline Strategy is generally used to mitigate potential "double tax" where the individual owns shares of a private corporation at the date of death.

Consider your typical client, Mr. White, who subscribed for shares in a private corporation ("Holdco"). Holdco acquired, grew, and eventually sold a successful widget business ("Opco"). Mr. White is retired and Holdco now owns $1 million of largely tax paid investments (e.g. cash from the sale proceeds of his widget business) and his shares of Holdco have a FMV of $1 million. Although the shares of Holdco owned by Mr. White have a FMV of $1 million, his adjusted cost base ("ACB") in those shares is a nominal amount ($100) which is the original capital contributed by Mr. White when he first subscribed for shares of Holdco, many years ago.

When he dies, Mr. White plans to leave his shares in Holdco to his kids, Vincent and Jules. Assuming the shares of Holdco have a FMV of $1 million at the date of death, the deemed disposition under section 70(5) will trigger a capital gain on the death of Mr. White of $999,900 and income tax of up to 19.5% of the gain. As a result, Vincent and Jules will inherit shares with a FMV of $1 million and ACB of $1 million. One may assume that Vincent and Jules can now receive the cash out of Holdco without paying any additional income tax. However, the only way to get the cash in Holdco into their personal wallets is by payment of a dividend from Holdco to the Estate which will trigger additional personal income tax of up to 27.71%. As such, the aggregate income taxes paid by the Holdco and the Estate is up to a whopping 55% (factoring in 14% corporate income tax paid by Opco on retained earnings of $1 million) far higher than the top marginal tax rate in Alberta of 39%. In order to avoid this potential "double tax", administrators of the Estate should consider implementing the Pipeline Strategy.

The first step of the Pipeline Strategy is for the Estate to incorporate a new corporation ("NewCo"). The Estate will then sell its shares of Holdco to NewCo in consideration for a $1 million promissory note. There is no taxable gain on the disposition of the shares of Holdco by The Estate to Newco because the Estate has ACB in its shares of Holdco of $1 million, as a result of the subsection 70(5) deemed disposition/acquisition.

Subsequent to the sale of the Holdco shares to Newco, the corporations complete an amalgamation (or wind-up), and effectively transfer all the assets (and liabilities) of the corporations into the merged corporation ("Amalco"). From there, Amalco can repay the promissory note to the Estate with $1 million cash its received on the merger with Holdco. The result is that the cash of Holdco can be transferred to the Estate and its beneficiaries without the Estate or beneficiaries having to receive a dividend from Holdco resulting in an income tax savings of up to 27.71%.

There are a number of landmines to consider when implementing the Pipeline Strategy, which go beyond the scope of this article, so it is important to have sound income tax advice before deciding to implement the series of transactions described above.

Concluding Comments

Estate administration, and the associated income tax consequences, can be extremely complicated. Although the CRA publishes many free guides to assist taxpayers and professionals with their estate planning matters, it is prudent to seek the assistance of experienced income tax advisors when dealing with these sorts of matters. If you enjoyed this article, please follow me on twitter @tax_litigator or add me to your professional network on LinkedIn.