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Post-Mortem Planning for Private Corporation Shares

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Deemed Disposition at Death of Capital Property at Fair Market Value

Paragraph 70(5)(a) of the *Income Tax Act* (Canada)[1] (the "Act") deems a taxpayer to have, immediately before the taxpayer's death, disposed of each capital property of the taxpayer and received proceeds of disposition equal to the fair market value ("FMV") of the capital property immediately before the taxpayer's death. As a result, the taxpayer's estate will realize accrued capital gains under paragraph 39(1)(a) and accrued capital losses under paragraph 39(1)(b) in respect of the taxpayer's capital property (and recapture under subsection 13(1) in respect of the taxpayer's depreciable capital property), and notwithstanding that there is no actual disposition for consideration of the taxpayer's capital property at death. One-half of any such capital gains (each a taxable capital gain under paragraph 38(1)(a)) must be netted against one-half of any such capital losses (each an allowable capital loss under paragraph 38(1)(b)) in excess of the taxpayer's allowable business investment losses for the year, and included in the taxpayer's last taxation year income under paragraph 3(b).

Generally, to the extent that a taxpayer's allowable capital losses in a year (in excess of the taxpayer's allowable business investment losses for the year) exceed the taxpayer's taxable capital gains for the year, the taxpayer may under paragraph 111(1)(b) and subparagraph 111(1.1)(a)(i) carry forward such net capital losses[2] and apply them against taxable capital gains (net of allowable capital losses) in all future years, and carryback such net capital losses and apply them against taxable capital gains (net of allowable capital losses) in the 3 prior years. Subsection 111(2) modifies the otherwise optional 3-year carryback and indefinite period carry-forward of net capital losses under paragraph 111(1)(b) for a taxpayer's year of death. Subsection 111(2) permits all unused net capital

1 All statutory references are to the provisions of the *Income Tax Act* (Canada), unless otherwise stated.

2 "net capital loss" is defined in subsection 111(8).

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losses arising in years up to and including the year of a taxpayer's death to be used to the extent needed to fully offset any taxable capital gains arising in the year of the taxpayer's death and in the immediately preceding taxation year. The historic income inclusion rate for capital gains is preserved for this purpose under subsection 111(1.1). To the extent that any such net capital losses exceed taxable capital gains in the year of the taxpayer's death and in the immediately preceding taxation year and the full amount of all section 110.6 capital gains deductions claimed by the taxpayer for any taxation year, such excess may be deducted in full against any business, employment or other income of the taxpayer in the year of the taxpayer's death and in the immediately preceding taxation year.[3]

Subsection 159(5) provides that, where a taxpayer's estate duly elects and provides the required security, the taxpayer's estate may pay the tax in respect of the net taxable capital gains arising as a result of the deemed disposition of a taxpayer's capital property under paragraph 70(5)(a) in up to 10 annual installments, and beginning on the day on which the estate would have otherwise been required to pay the tax had the election not been made, with interest at the prescribed rate[4] on the balance outstanding.

Paragraph 70(5)(b) deems any person who as a consequence of the taxpayer's death acquires any capital property which is deemed to be disposed of by the taxpayer under paragraph 70(5)(a) to have acquired the property at the time of the death at a cost equal to the FMV of the property immediately before the death.

Subsection 70(6) provides a deferral from the tax which would otherwise arise as a result of the deemed disposition under paragraph 70(5)(a) of a Canadian resident taxpayer's capital property at death where the deceased taxpayer's capital property is transferred as a consequence of the taxpayer's death to the deceased taxpayer's spouse or common-law partner who is a resident of Canada immediately before the taxpayer's death, or to a resident Canadian qualifying spouse or common-law partner trust. In such case, paragraph 70(6)(d) deems the deceased taxpayer, immediately before the taxpayer's death, to have disposed of each capital property owned by the taxpayer immediately before death for proceeds of disposition equal to, (i) in the case of depreciable capital property, the lesser of the deceased taxpayer's capital cost and cost amount of the depreciable capital property immediately before the death, and (ii) in any other case, the deceased taxpayer's adjusted cost base ("ACB") of the capital property immediately before the death, and the surviving spouse or common-law partner or qualifying spouse or common-law partner trust is deemed to have acquired the property for such proceeds. The taxpayer's legal representative may elect under subsection 70(6.2) not to have the subsection 70(6) rollover apply, in which event the general rule in subsection 70(5) will apply.

Where a Canadian resident taxpayer at his or her death owns shares of a private corporation which each meet the conditions for being a "qualified small business corporation share" in subsection 110.6(1) at any time during the 12 month period immediately prior to the taxpayer's death[5], the taxpayer's estate may claim the capital gains deduction (subject to a lifetime limit (in 2023) of $485,595, or $971,190 of capital gains, and indexed annually) on the taxable capital gain arising on the deemed disposition of the deceased taxpayer's shares under paragraph 70(5)(a), and after adjusting for the taxpayer's cumulative net investment

3 See paragraph 30 of Interpretation Bulletin 232R3 – Losses, Their Deductibility in the Loss Year or in Other Years dated July 4, 1997.

4 The prescribed rate of interest is calculated and published quarterly under section 4301 of the Income Tax Regulations.

5 See paragraph 110.6(14)(g).

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loss, previously claimed allowable business investment losses, and certain capital losses. The "qualified small business corporation share" deduction is shared with a $500,000 deduction (or $1,000,000 of capital gains) for dispositions of a qualified farm property or a qualified fishing property.[6]

Potential for Double Taxation on the Deemed Disposition of Shares of a Private Corporation

There is a potential for double taxation where shares of a private corporation which have an accrued but untaxed gain associated with them have been deemed pursuant to paragraph 70(5)(a) to be disposed of as a consequence of the death of a taxpayer who owned the shares at the time of his or her death, and for proceeds equal to the FMV of the shares immediately before the taxpayer's death, and where the shares are not bequeathed to the deceased taxpayer's spouse or common-law partner or to a qualifying spouse or common-law partner trust.

In the absence of any planning, the shares will be subsequently distributed by the estate to its Canadian resident beneficiaries at the adjusted cost base to the estate[7] of the shares, and unless the estate's legal representative makes an election to distribute the shares at their FMV[8]. Where the corporation at the time of the taxpayer's death owns assets which have accrued but untaxed gains associated with them - which gains are otherwise reflected in the gain in the value of the shares taxed at the deceased taxpayer's death – the corporation will realize those taxable gains on a subsequent disposition of the assets. The deemed disposition of the deceased taxpayer's shares will not automatically increase the tax cost of the corporation's assets by the amount of the gain inherent in the deceased's shares which is taxed at the deceased's death. If the after-tax proceeds are distributed as dividends by the corporation to the taxpayer's beneficiaries (following the transmission of the shares of the corporation to the taxpayer's beneficiaries), one dividend will constitute a non-taxable capital dividend (to the extent of the corporation's capital dividend account, and to the extent an election is made by the corporation to treat the dividend as a capital dividend) and another dividend will constitute a separate, taxable dividend. Double taxation arises as a result of the taxation of the gain in the shares owned by the deceased taxpayer, the taxation of the gain inherent in the corporation's assets which is reflected in the gain in the deceased's shares, and on the distribution by the corporation to the beneficiary shareholders of the after-tax proceeds of the corporation's assets.

The corporation might instead of paying dividends to the beneficiary shareholders redeem their shares with the after-tax proceeds of the sale of the corporation's assets. A portion of the resulting deemed dividends (in excess of the paid-up capital ("PUC") of the shares) will constitute a capital dividend (to the extent of the corporation's capital dividend account, and to the extent an election is made) and the remaining portion a taxable dividend. The beneficiary shareholders will realize a capital loss to the extent of the excess of the ACB of the shares over their PUC, subject to the stop-loss provisions in subsections 40(3.6) and 112(3) discussed below. The beneficiary shareholders may not though carry back the loss to recover taxes paid by the taxpayer's estate on the capital gain arising on the deceased taxpayer's death, and may only apply the capital loss against capital gains realized by them in the three years prior or in any following year. Double taxation again arises to the extent the beneficiary shareholders do not realize capital gains against which the capital losses can be applied.

The above double tax exposure to the

6 See subsections 110.6(2), 110.6(2.1), and 110.6(2.2).
7 See subsection 107(2).
8 See subsection 107(2.001).

beneficiaries would be avoided if the shares of the corporation, which now have an ACB equal to their FMV at the taxpayer's death, are subsequently sold by the beneficiaries.

Methods for Reducing Double Taxation

This article discusses three methods for reducing the exposure to double taxation arising from the deemed disposition of a taxpayer's shares of a private corporation at death and to the extent it cannot be avoided by a share sale: the subsection 164(6) loss carryback, the so-called post-mortem "pipeline", and the paragraph 88(1)(d) winding-up or amalgamation bump. It does not consider post-mortem planning for private corporation shares owned by testamentary spousal or common-law partner trusts, nor by inter vivos alter ego, joint-spousal or common-law partner trusts.

In very general terms, and where permitted under the deceased's will[9], each of the subsection 164(6) loss carryback and post-mortem "pipeline" methods facilitate the extraction from a corporation of the value of a deceased taxpayer's shares, and can be structured to result in a single incidence of tax to the taxpayer's estate, (i) in the case of a subsection 164(6) loss carryback, a taxable dividend to the estate at some time in the year following the deceased's death, or (ii) in the case of a post-mortem pipeline, a capital gain arising from the deemed disposition of the deceased taxpayer's shares at death.

The subsection 164(6) loss carryback, which must be implemented in the year following the taxpayer's death, permits a taxpayer's graduated rate estate to redeem or sell for cancellation the deceased taxpayer's shares, or receive a distribution of a corporation's assets on a winding-up of the corporation, and incur a dividend, and also to carry-back the capital loss arising from the redemption or purchase of the shares to the taxpayer's last taxation year to fully or partially eliminate the capital gain arising on the deemed disposition of the taxpayer's shares on his or her death. The availability of the subsection 164(6) loss carryback may be limited by the stop-loss rules in subsections 40(3.6) and 112(3.2), discussed below.

Where it is available to an estate, the post-mortem pipeline permits a distribution of assets from a corporation to its shareholders equal to the value of the deceased taxpayer's shares at death - and where a capital gain is realized on the deemed disposition of the taxpayer's shares – and without a separate taxable dividend being triggered by the distribution of the assets.

Finally, and where it is available to an estate, the paragraph 88(1)(d) winding-up or amalgamation bump may be used by a taxpayer's estate to increase, or "bump", the ACB of a corporation's non-depreciable capital property owned by the corporation at the taxpayer's death.

The subsection 164(6) loss carryback, the post-mortem pipeline, and the paragraph 88(1)(d) winding-up or amalgamation bump may be combined with each other, and where the combination achieves a lower incidence of tax to a taxpayer's estate than might be achieved by implementing one or two of the methods alone.

The decision to use one or more of the various post-mortem planning methods will depend on the tax attributes of, including accrued gains in, the corporation's assets and the corporation's tax accounts, including the corporation's capital dividend ("CDA"), general rate income pool ("GRIP"), and eligible and ineligible refundable

9 Some of the estate trustee powers which should be included a deceased's will to grant to the estate trustees the power to carry out post-mortem planning include the power to incorporate corporations, the power to act as a director of a corporation, the power to engage in tax-motivated reorganizations, the power to make tax elections and designations, the power to purchase and stay invested in private corporation shares, the power to carry on business, the power to distribute assets in specie, and the power to borrow.

dividend tax on hand ("RDTOH") balances at the time of the taxpayer's death, and the circumstances and intentions of the deceased taxpayer's legal personal representatives and beneficiaries. As an example, the top combined federal/provincial marginal tax rate for individuals in Ontario[10] and on regular income above $220,000 is currently (in 2023) 53.53%, and at this highest tax rate 26.76% on capital gains, 39.34% on eligible dividends and 47.74% on non-eligible dividends. Since the rate of tax on taxable dividends significantly exceeds the rate of tax on capital gains, generally an estate would prefer the post-mortem pipeline method, and where it is available to the estate, over the subsection 164(6) loss carryback, except where the corporation has, (i) a CDA balance which reduces the effective tax rate on the deemed dividend resulting from the redemption of the estate's shares of the corporation, (ii) a GRIP balance from which eligible dividends can be paid (where eligible dividends are taxed at a lower rate than non-eligible dividends), and/or (iii) an RDTOH balance which results on the payment of a taxable dividend in a refund to the corporation of tax previously paid on investment income. Where though the estate or the beneficiaries choose to wind-up a corporation and distribute the corporation's assets within a short time of the taxpayer's death, the estate or the beneficiaries may accept the higher dividend tax rate resulting from the wind-up in order to achieve the near-term winding-up of the corporation.

The following is a more detailed discussion of the various post-mortem planning methods available to an estate.

Subsection 164(6) Loss Carryback

Estate Administration Generally

When a taxpayer dies, the taxpayer's estate (represented by the taxpayer's executors or administrators, that is the taxpayer's legal representatives[11]) is treated as a trust, and a separate taxpayer, during the period during which the deceased's affairs are wound up and the deceased taxpayer's assets are distributed to the beneficiaries of the deceased's estate.[12] A taxpayer's graduated rate estate may adopt a taxation year ending not more than 12 months following the taxpayer's death.[13] A graduated rate estate will have a deemed taxation year-end on the earlier of the day on which its assets are distributed to the beneficiaries of the estate and the day which is 36 months following the date of death of the deceased taxpayer.[14]

Subsection 159(2) requires a legal representative of a deceased taxpayer, before distributing to the taxpayer's beneficiaries any property in the possession or control of the legal representative acting in that capacity, to obtain a clearance certificate from the Minister of National Revenue by applying in prescribed form[15] and certifying that all income tax which the deceased taxpayer or the legal representative is or may become liable for prior to the distribution has been paid or security for payment thereof has been accepted by the Minister. Subsection 159(3) provides that the legal representative is personally liable for any tax, interest and penalties to the extent of the value of any property distributed by the legal representative prior to obtaining a clearance certificate. Paragraph 2 of Information Circular IC 82-6R11 - Clearance Certificate[16] states that a legal representative does not need a clearance certificate before each distribution, as long as the legal representative retains enough property

10 All identified income tax rates assume that the taxpayer is resident in Ontario, unless otherwise stated.

11 The definition of "legal representative" in subsection 248(1) includes an administrator or executor of a deceased taxpayer's estate.
12 See subsection 104(1).
13 See paragraph 249(1)(b) and subsection 249(5).
14 See subparagraph 249(4.1)(a)(ii).
15 See CRA form TX19: Asking for a Clearance Certificate.
16 Dated November 25, 2015.

to pay any outstanding tax liability.

Graduated Rate Estate

Since 2016, all special relief in the Act that previously applied to a testamentary trust applies only to a "graduated rate estate". This relief includes graduated marginal tax rates[17], and the relief otherwise available under subsection 164(6) to carry back a capital loss realized in the year following a taxpayer's death arising from the disposition of shares of a corporation held by a taxpayer's estate to offset a capital gain realized in the taxpayer's final year from the deemed disposition of the shares.

A "graduated rate estate" of an individual is defined in subsection 248(1) as an estate arising on and as a consequence of the individual's death if:

(a) not more than 36 months has passed since the individual's death;
(b) the estate is a testamentary trust;
(c) the estate in its return for its first taxation year designates itself as a graduated rate estate, and no other estate so designates itself as the graduated rate estate of the individual; and
(d) the estate identifies the deceased's social insurance number in its returns.

Generally, an estate of an individual is a testamentary trust except where, (i) property has been contributed to the estate by any person other than the individual and as a consequence of the individual's death, or (ii) the estate incurs a debt or other obligation to, or which is guaranteed by, a beneficiary of the estate or any person or partnership who does not deal at arm's length with a beneficiary of the estate (a "specified party"), except a debt or obligation, (A) incurred by the estate in satisfaction of a right of the specified party as a beneficiary of the estate to enforce the payment of an amount of the estate's income or capital gains payable by the estate to the specified party or otherwise to receive any part of the capital of the estate, (B) owed to the specified party in respect of a service rendered by the specified party to, for or on behalf of the estate, or (C) owed to the specified party if the debt or other obligation arose because of a payment made by the specified party for or on behalf of the estate, the estate repays the debt or obligation in full within 12 months of the payment or such longer period as may be permitted by the Minister of National Revenue, and it is reasonable to conclude that the specified party would have been willing to make the payment had the specified party dealt at arm's length with the estate, except where the payment is made within 12 months of the individual's death or such longer period as may be permitted by the Minister.[18]

Where an estate does not qualify as a graduated rate estate, the taxation rules otherwise applicable to inter vivos trusts will apply to the estate.

The Department of Finance in its Technical Notes (October 30, 2014) states that an individual can have only one estate, and notwithstanding that the individual has multiple wills. The Canada Revenue Agency ("CRA") has confirmed this position, stating that an individual's estate for the purposes of the definition of a graduated rate estate includes all of the individual's worldwide property owned at death, and notwithstanding that the individual may have multiple wills dealing with such property.[19]

Mechanics of the Subsection 164(6) Loss Carryback

Subsection 164(6) provides that, where in the course of administering a graduated rate estate

17 See subsection 122(1). Paragraph 122(1)(a) provides that all trusts, other than a graduated rate estate or a qualified disability trust, pay tax at the top marginal rate, currently 53.53% in Ontario.

18 "testamentary trust" is defined in subsection 108(1).
19 STEP CRA Roundtable Q.2, CRA Document no. 2015-0572091C6.

(referred to as an “estate” in the discussion below) of a deceased taxpayer, the deceased taxpayer’s legal representative has, within the first taxation year of the estate following the date of death of the taxpayer, disposed of capital property of the estate so that the total of all capital losses realized by the estate on the disposition of its capital property exceeds the total of all capital gains realized by the estate on the disposition of its capital property, the legal representative may elect[20] to treat the net capital loss as a capital loss of the deceased taxpayer from the disposition of the property by the deceased taxpayer in the taxpayer’s last taxation year. Since a capital loss carried back under subsection 164(6) is deemed to be a capital loss arising in the year of death, the loss is subject to the provisions of subsection 111(2). Accordingly, the portion of any net capital loss from the disposition of capital property by the estate so carried back to the deceased taxpayer’s last taxation year in excess of any taxable capital gain arising from the deemed disposition of the capital property at the taxpayer’s death and any other remaining taxable capital gains arising in the year of the taxpayer’s death or a preceding taxation year may be deducted in full against any other income for the taxpayer’s last year, and after reducing such excess net capital loss by the full amount of all section 110.6 capital gains deductions claimed by the taxpayer for any taxation year.

In addition to filing an election under subsection 164(6), the deceased taxpayer’s legal representative is required under paragraph 164(6)(e) to file an amended tax return for the deceased taxpayer’s last taxation year, though the CRA will accept a T1 adjustment reflecting the required prescribed information.

The capital loss can be realized by the deceased taxpayer’s estate within the estate’s first taxation year where the corporation redeems or purchases for cancellation all or a portion of the shares of the corporation held by the estate, or where the corporation distributes its assets to the estate on the winding-up of the corporation under subsection 88(2). In the former case, the estate will be deemed by virtue of subsection 84(3) to have received a dividend to the extent that the redemption or purchase proceeds received for the redeemed or purchased shares exceeds the PUC of the shares. The redemption or purchase will also be a disposition of the shares, and will result in a capital loss to the extent that the PUC of the shares (deemed to be the proceeds of disposition from the redemption of the shares, as paragraph (j) of the definition of “proceeds of disposition” in section 54 does not include proceeds to the extent that they are deemed by subsection 84(3) to be a dividend) is less than the high (FMV at the time of the taxpayer’s death) ACB of the shares. In the latter case, the estate will be deemed by virtue of subsection 84(2) to have received a dividend equal to the amount by which the amount or value of the funds or property distributed to the estate exceeds the amount by which the PUC of the shares held by the estate is reduced on the distribution. The winding-up of the corporation will result in a disposition by the estate of its shares of the corporation, and will result in a capital loss to the extent that the PUC of the shares (again deemed to be the proceeds of disposition from the redemption of the shares, as paragraph (j) of the definition of “proceeds of disposition” in section 54 does not include proceeds to the extent that they are deemed by subsection 84(2) to be a dividend) is less than the high (FMV at the time of the taxpayer’s death) ACB of the shares.

Tax Rates on Deemed Dividends vs. Capital Gains

By implementing the subsection 164(6) loss carryback, a taxpayer’s estate can minimize the potential double taxation which might otherwise result from the deemed realization on

20 The requirements of the election are set out in Section 1000 of the Income Tax Regulations. Subsection 164(6) is one of the prescribed provisions in paragraph 600(b) of the Income Tax Regulations for which a taxpayer may apply under subsection 220(3.2) to late file an election.

a taxpayer's death of a capital gain arising on the deemed disposition of the taxpayer's shares of a private corporation by redeeming the estate's shares in the first year following the taxpayer's death and triggering a deemed dividend, and carrying the resultant loss back to the taxpayer's last taxation year to reduce or eliminate the capital gain.

The subsection 164(6) loss carryback results though in the accrued gain in the shares being taxed as an eligible (where it is paid out of the corporation's GRIP or non-eligible (where it is paid out of the corporation's low rate income pool) dividend, rather than as a capital gain.

The tax rate applicable to an eligible dividend (at the highest tax rate in Ontario, 39.34%) or a non-eligible dividend (at the highest tax rate in Ontario, 47.74%) currently significantly exceeds the effective tax rate on a capital gain arising from the deemed disposition of the taxpayer's shares on his or her death (at the highest tax rate in Ontario, 26.76%).

This effective tax rate on a deemed dividend arising from the redemption of the estate's shares can be reduced, however, where a corporation has and/or can generate a CDA balance. The deemed dividend under subsection 84(3) and resulting from a redemption or purchase for cancellation in the year following death of shares of a corporation held by a taxpayer's legal representative, or under subsection 84(2) and paragraph 88(2)(b) on a distribution of the assets of a corporation in the course of its winding–up in the year following death and in respect of the shares of the corporation held by a taxpayer's legal representative, will, subject to the stop–loss rule in subsection 112(3.2) discussed below, be tax-free to the extent that it is the subject of a capital dividend election under subsection 83(2).[21] Where a corporation has and/or can generate RDTOH, it will be entitled to a refund of RDTOH to the extent that the deemed dividend arising on a redemption of its shares is a taxable dividend.

A corporation's CDA[22] generally consists of the untaxed one-half of any capital gains realized by the corporation, and the proceeds of exempt life insurance, minus the adjusted cost basis of the life insurance, received by the corporation, and is used to pay out tax free capital dividends to the corporation's shareholders under subsection 83(2). A corporation's RDTOH[23] is a notional account that includes the otherwise high initial corporate tax paid on the corporation's income from property, including interest and rental income.[24] A corporation is entitled to a dividend refund equal to 38 1/3% of taxable dividends paid or deemed to be paid by it, and to a maximum of the corporation's RDTOH.[25]

A corporation's CDA may result from an existing balance, the receipt by the corporation of an exempt life insurance death benefit, and from the disposition by the corporation in the year following the taxpayer's death (and prior to the winding-up of the corporation) of capital property with accrued gains. A corporation's RDTOH may result from an existing balance and from the disposition by the corporation in the year following the taxpayer's death (and prior to the winding-up of the corporation) of capital property with accrued gains. Accordingly, a deceased's legal

21 An election under subsection 83(2) to treat a dividend as a capital dividend may only be made in respect of the full amount of the dividend.

22 "capital dividend account" is defined in subsection 89(1).

23 "refundable dividend tax on hand" is defined in subsection 129(3).

24 The temporary high corporate tax on property income and subsequent dividend refund on the payment of taxable dividends to a corporation's shareholders is intended to prevent a deferral of tax on property income earned through a corporation, rather than by an individual directly, but to otherwise result in the combined tax paid by a corporation and its individual shareholder being equal to the tax paid on such income by the individual had the individual earned the income directly, i.e. achieving so-called integration between an individual's earning property income through a corporation and the individual's earning the property income directly.

25 The dividend refund is calculated and payable to a corporation under subsection 129(1).

representative may choose to cause a corporation to transfer its assets to a related entity in the year following the deceased's death, and in order to crystallize accrued gains, and for the purpose of generating CDA and RDTOH. This approach can also be used to increase the tax cost of capital property, including depreciable property, owned by the corporation, although it may also result in the recapture of previously claimed capital cost allowance. The cost of depreciable property may not otherwise be bumped under subsection 88(1), discussed below, and because it is not eligible for any cost base bump by virtue of subparagraph 88(1)(c)(iii).

Where the deceased taxpayer is not the only shareholder of a corporation at the taxpayer's death, consideration should be given to the other shareholders when deciding to elect to trigger a deemed dividend or pay a dividend to the deceased taxpayer's estate out of the corporation's CDA, and to the extent that the other shareholders do not benefit from such use of the corporation's CDA.

Affiliated Stop Loss Rule on a Redemption or Purchase for Cancellation of Shares – Subsection 40(3.6)

Where a taxpayer disposes of a share (other than a "distress preferred share"[26]) of a corporation to the corporation and the taxpayer and the corporation are affiliated immediately after the disposition, subsection 40(3.6) provides that any loss on the disposition is deemed to be nil, and the amount of the loss (determined without reference to subsection 40(3.6)) is added to the taxpayer's ACB of any other shares of the corporation held by the taxpayer after the disposition. The ACB increase is allocated among the remaining shares, if any, in proportion to the relative FMVs of the shares. If the taxpayer does not hold any shares of the corporation after the disposition, the loss will be denied.

26 Defined in subsection 80(1).

An estate will be affiliated with a corporation following a redemption or purchase for cancellation of the estate's shares of the corporation where, immediately following the redemption or purchase for cancellation, the estate controls, directly or indirectly in any manner whatever, the corporation.[27]

An estate will also be affiliated with a corporation following a redemption or purchase for cancellation of the estate's shares of the corporation where, immediately following the redemption or purchase for cancellation, the corporation is controlled, directly or indirectly in any manner whatever, by a "majority interest beneficiary" of the estate.[28] A "majority interest beneficiary"[29] of a trust is a person whose interest as a beneficiary, (i) in the income of the trust has, together with the interests as a beneficiary in the income of the trust of all persons with whom the person is affiliated, exceeds 50% of the FMV of all of the interests as a beneficiary in the income of the trust, or (ii) in the capital of the trust, together with the interests as a beneficiary in the capital of the trust of all persons with whom the person is affiliated, exceeds 50% of the FMV of all of the interests as a beneficiary in the capital of the trust. Accordingly, where a majority interest beneficiary of an estate controls a corporation immediately following the redemption or

27 See subparagraph 251.1(1)(b)(i). "Controlled" for the purposes of section 251.1 is defined in subsection 251.1(3) as controlled, directly or indirectly in any manner whatever, and includes de facto control (see subsection 256(5.1)). Generally a person controls a corporation if the person has the right to elect a majority of the members of the board of directors of the corporation, i.e. de jure control. De jure control is normally determined by reference to a corporation's constating documents, being its articles, by-laws, share register and any unanimous shareholder agreement (see *Duha Printers (Western) Ltd. V. Canada*, [1998] 3 C.T.C. 3030 (SCC)).
28 Under subparagraph 251.1(1)(g)(ii), a person (which includes a corporation under the subsection 248(1) definition of "person") and a trust are affiliated if that person is affiliated with a majority-interest beneficiary of the trust otherwise than by virtue of paragraph 251.1(1)(g).
29 Defined in subsection 251.1(3).

purchase for cancellation of the estate's shares of the corporation, the estate and the corporation will be affiliated with each other.

Paragraph 251.1(4)(c) provides that, notwithstanding subsection 104(1), the identity of a deceased taxpayer's legal personal representatives is not to be considered for the purpose of the affiliated person rules in subsection 251.1(1). Accordingly, a legal personal representative's owning shares of a corporation in his or her personal capacity will not be considered in determining whether the estate controls the corporation, except where the legal personal representative is also a majority interest beneficiary of the estate.

By virtue of paragraph 69(5)(d), subsection 40(3.6) will not apply in respect of a deemed disposition of property of the corporation under subsection 69(5) on an appropriation of the property by a shareholder of the corporation on a taxable winding–up of the corporation. Accordingly, the application of subsection 40(3.6) can be avoided where an estate disposes of shares of the corporation by way of a taxable winding–up of the corporation.

Subsection 40(3.61) Exception to Subsection 40(3.6) Stop Loss Rule

Subsection 40(3.61) contains an exception to the application of subsection 40(3.6) to a redemption or purchase for cancellation of a share of a corporation held by an estate in the course of a subsection 164(6) loss carryback. Subsection 40(3.61) provides that, where a legal representative in the course of administering a deceased taxpayer's estate elects under subsection 164(6) to treat all or any portion of the estate's capital loss (determined without reference to subsection 40(3.6)) arising from the redemption or purchase for cancellation of a share of a corporation to be the deceased taxpayer's loss from the disposition of the share, subsection 40(3.6) will apply only to that portion of the loss which exceeds the portion of the loss to which the subsection 164(6) election applies.

Accordingly, subsection 40(3.61) will provide relief from the stop-loss rule in subsection 40(3.6) where an estate realizes a capital loss from the disposition of its shares of a corporation (in excess of any capital gains realized by the estate in the year following the taxpayer's death), and the estate elects under subsection 164(6) to carry back the loss to the deceased's final taxation year.[30]

Capital Dividend Stop Loss Rule – Subsection 112(3.2)

Subsection 112(3.2) reduces the amount of the loss of a trust (other than a mutual fund trust) from the disposition of a share of a corporation[31] by the total of:

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30 See CRA Document no. 2020-0847181C6 STEP 2020 – Q5 - Subsections 40(3.61) and 164(6) dated November 26, 2020, for the CRA's comments on the impact on a subsection 164(6) loss carryback of capital gains realized by an estate in its first taxation year.

31 There are a number of grandfathering rules excepting the application of the stop-loss rule in subsection 112(3.2) to certain share dispositions, which rules were introduced when subsection 112(3.2) was passed into law in 1995. These include a disposition of a share of the capital stock of a corporation that is made to the corporation if:

(i) on April 26, 1995 the share was owned by an individual (other than a trust) or by a particular trust under which an individual (other than a trust) was a beneficiary,

(ii) on April 26, 1995 a corporation, or a partnership of which a corporation is a member, was a beneficiary of a life insurance policy that insured the life of the individual or the individual's spouse,

(iii) it was reasonable to conclude on April 26, 1995 that a main purpose of the life insurance policy was to fund, directly or indirectly, in whole or in part, a redemption, acquisition or cancellation of the share by the corporation that issued the share, and

(iv) the disposition is made by the estate of the individual within the estate's first taxation year.

See subsection 131(11) of the *Income Tax Amendments Act*, 1997, as amended by subsection 251(1) of the *Income Tax Amendments Act*, 2000, SC 2001, c. 17.

(a) the amount, if any, by which the lesser of,
   (i) any capital dividend received by the trust on the share, and
   (ii) the loss otherwise determined less any taxable dividend:
      (A) received by the trust on the share,
      (B) received on the share and designated under subsection 104(19) by the trust in respect of a beneficiary who is an individual (other than a trust), or
      (C) that is a qualified dividend received on the share and designated under subsection 104(19) by the trust in respect of a beneficiary that was a corporation, partnership or another trust where the trust establishes that
         (I) it owned the share throughout the 365-day period that ended immediately before the disposition, and
         (II) the dividend was received while the trust, the beneficiary and persons not dealing at arm's length with the beneficiary owned in total less than 5% of the issued shares of any class of the corporation from which the dividend was received,

exceeds

   (iii) if the trust is an individual's graduated estate, the share was acquired as a consequence of the individual's death, and the disposition occurs during the trust's first taxation year, one-half of the lesser of:
      (A) the loss otherwise determined,
      (B) the individual's capital gain from the disposition of the share immediately before the individual's death, and

(b) the total of all taxable dividends or life insurance capital dividends received on the share and designated under subsection 104(19) or (20) by the trust in respect of a beneficiary that was a corporation, partnership or trust.

This stop-loss rule was introduced into the Act to prevent an estate from realizing a nil tax liability when life insurance was used to fully fund the redemption or purchase for cancellation of private corporation shares. Subsection 112(3.2) operates after first applying the rule in subsection 40(3.6). If a loss is not first denied by subsection 40(3.6), it is potentially reduced by subsection 112(3.2). Further, unlike subsection 40(3.6), a reduction of a loss of an estate under subsection 112(3.2) may not be added back to the ACB of other shares owned by the estate, and is denied.

Subparagraph 112(3.2)(a)(iii) sets out an exception to the stop-loss rule in subsection 112(3.2) where, (i) the share is disposed of by a trust which is a graduated rate estate, (ii) the share was acquired by the graduated rate estate as a consequence of the death of an individual, and (iii) the share disposition occurs in the first year following the individual's death. In this circumstance, the amount of the reduction to the loss under subsection 112(3.2) on the disposition of a share is reduced by one-half of the lesser of, (A) the loss otherwise determined, and (B) the deceased individual's capital gain arising on the deemed disposition of the share on the individual's death.

Accordingly, to avoid a reduction under subsection 112(3.2) in the loss resulting from the disposition of a share held by a graduated rate estate in the year following the deceased's death, the amount of the deemed dividend arising from the disposition of the share by the estate which is the subject of a subsection 83(2) capital dividend election should not exceed one-half of the lesser of the loss arising on

the disposition of the share and the deceased taxpayer's capital gain resulting from the deemed disposition of the share immediately before the deceased's death. Since an election under subsection 83(2) to treat a dividend as a capital dividend can only be made in respect of the full amount of the dividend, and where the loss reduction under subsection 112(3.2) is computed on a share-by-share basis[32], a capital dividend and a taxable dividend must be paid in separate transactions on each share of the estate being redeemed. These separate transactions in respect of each share can be achieved by, first, an increase to the legal stated capital (and PUC) of the share (the amount of the increase deemed to be a dividend under subsection 84(1))[33], and, second, the redemption of the share (the excess of the redemption price of the share over its (now increased) PUC deemed to be a separate dividend under subsection 84(3)).

Where a share (an "old share") is exchanged for a new share in a tax-deferred transfer to which section 51, 85.1, 86, or 87 (but not section 85) applies, subsection 112(7) deems for the purposes of the stop-loss rule in subsection 112(3.2) the new share to be the same share as the old share, and all dividends received on the old share to be dividends received on the new share.

Potential Application of Part VI.1 Tax

Subsection 191.1(1) of Part VI.1 provides for a special tax payable by a taxable Canadian corporation on dividends, other than an "excluded dividend"[34], paid by the corporation on "taxable preferred shares" in excess of an annual "dividend allowance"[35] of up to $500,000. The allowance is shared among associated corporations and is reduced by certain dividends paid in the prior calendar year.

A "taxable preferred share"[36] is a "short-term preferred share" or a share of a corporation which, by reason of the terms and conditions of the share or any agreement in respect of the share or its issue to which the corporation, or a "specified person" in relation to the corporation[37], is a party:

(a) the amount of dividends which may be declared or paid on the share (the "dividend entitlement") is fixed, limited to a maximum, or not less than a minimum;
(b) the amount that the shareholder is entitled to receive on the dissolution or winding-up of the corporation, or on the redemption, acquisition or cancellation of the share is fixed, limited to a maximum, or not less than a minimum;
(c) the share is convertible or exchangeable, unless the conversion is to another security that would not otherwise be a taxable preferred share; or
(d) a person, other than the corporation, is obligated as a result of a transaction or series of transactions that included the issuance of the share to ensure that any loss that the shareholder or a specified person in relation to the shareholder may sustain by reason of the ownership, holding or disposition of the share is limited in any respect or that the shareholder or a specified person in relation to the shareholder will derive earnings by reason of the ownership, holding or disposition of the share.

A "short-term preferred share"[38] is a share where, under the terms and conditions of the share or

32 See CRA Document no. 2007-0224371I7.
33 The ACB of the share will be increased by the amount of the increase in the PUC of the share which is deemed by subsection 84(1) to be a dividend on the share. See subparagraph 53(1)(b)(i).
34 Defined in subsection 191(1).
35 Defined in subsections 191.1(2) and (4).

36 Defined in subsection 248(1).
37 Defined in paragraph (h) of the definition of "taxable preferred share" in subsection 248(1) as another person with whom the corporation does not deal at arm's length or any partnership or trust of which the corporation or the other person is a member or beneficiary.
38 Defined in subsection 248(1).

any agreement to which the corporation or a specified person in relation to the corporation is a party, the corporation is or may be required to redeem, acquire or cancel the share (unless arising only in the event of the death of the shareholder or by reason of a right to convert or exchange the share) or reduce the PUC of the share within 5 years after the date of its issue.

Part VI.1 tax payable by a corporation can be offset against tax payable by the corporation under Part I of the Act by a deduction under paragraph 110(1)(k).

Generally, a redemption or purchase for cancellation of shares held by a taxpayer's estate which are "taxable preferred shares" for the purposes of Part VI.1 will avoid Part VI.1 tax where the deemed dividend resulting from the redemption of the shares is an "excluded dividend" as a result of:

(a) the estate having a "substantial interest" in the corporation[39] under subsection 191(2) (i.e. the estate, immediately prior to the redemption, was related to the corporation or held shares carrying 25% or more of the votes attaching to all shares of the corporation and having a FMV of 25% or more of the FMV of all of the shares of the corporation), or

(b) the corporation being a "private holding corporation"[40] as that term is defined in subsection 191(1) (i.e. a private corporation the only undertaking of which is the investing in funds, other than a private corporation which owns shares of another corporation in which it has a substantial interest where the other corporation's only undertaking is not the investing of funds), or

the terms and conditions of the shares (at the time of issuance or by a subsequent change) or an agreement in respect of the shares specify an amount in respect of the shares, including an amount for which the shares are to be redeemed, acquired or cancelled (together with, where provided, any accrued and unpaid dividends thereon) and the specified amount does not exceed the FMV of the shares and the shares were not issued for consideration that included a taxable preferred share.[41]

If any of the foregoing conditions are not present, there is a $500,000 annual dividend allowance under paragraph 191.1(2)(a) exempting from Part VI.1 tax dividends up to the amount of this $500,000 annual allowance paid on taxable preferred shares.

In the context of an estate freeze, where a shareholder does not otherwise have a "substantial interest" in a corporation under subsection 191(2), consideration should be given when freezing the shareholder's equity share interest in the corporation to using fixed value preferred shares with a redemption price fixed at a specific amount per share (e.g., $1 per share), rather than fixed value preferred shares with a redemption price calculated on the basis of the FMV of the consideration received by the corporation upon the issuance of the shares. Consideration should also be given to whether the terms and conditions of the shares include a price adjustment clause ("PAC"). The CRA has stated that a PAC that is included in the terms or conditions of a taxable preferred share will not in and of itself negate the amount specified in subsection 191(4). If though the PAC becomes operative to increase the original redemption amount of the shares to an amount in excess of the specified amount, the excess deemed dividends will not qualify as excluded dividends; however, the original deemed dividends will continue to qualify as excluded dividends.
If though the PAC operates to reduce the

39 See paragraph (a) of the definition of "excluded share" in subsection 191(1).

40 See paragraph (b) of the definition of "excluded share" in subsection 191(1).

41 See subsection 191(4).

redemption amount of the shares to an amount less than the specified amount, the entire amount of the original deemed dividends will be disqualified as excluded dividends.[42]

Post-Mortem Pipeline

The subsection 164(6) loss carryback converts what would otherwise be a capital gain on the deemed disposition of a deceased taxpayer's shares of a corporation at the taxpayer's death into a deemed dividend to the taxpayer's estate arising on the redemption or purchase for cancellation of the shares during the year following the taxpayer's death.

Since the tax rate applicable to dividends (at the highest tax rate in 2023 in Ontario, 39.34% on eligible dividends and 47.74% on non-eligible dividends) currently significantly exceeds the tax rate on capital gains (at the highest tax rate in Ontario in 2023, 26.76%), a deceased taxpayer's legal representative may (unless there is a preference to wind-up the corporation shortly after the taxpayer's death) prefer to have an accrued gain on the deceased taxpayer's shares taxed as a capital gain, rather than a dividend, and unless the corporation has, (i) RDTOH which would be refunded to the corporation to the extent that the deemed dividend is a taxable dividend, (ii) a GRIP balance from which eligible dividends can be paid (where eligible dividends are taxed at a lower rate than non-eligible dividends), and/or (iii) a CDA balance which could be used to reduce the effective tax cost of the deemed dividend arising from a disposition of the estate's shares.

Like the subsection 164(6) loss carryback, a post-mortem pipeline, to the extent that it is available to an estate, can be used to facilitate the reduction or elimination of double taxation which might otherwise arise, firstly, on the deemed disposition on a taxpayer's death of the taxpayer's shares of a private corporation, secondly, on the distribution by the corporation to the beneficiary shareholders of tax paid assets of the corporation. Unlike the subsection 164(6) loss carryback, a post-mortem pipeline preserves the capital gain arising on the deemed disposition of the taxpayer's shares on the taxpayer's death, while facilitating the tax-free distribution of tax paid assets of the corporation to the taxpayer's beneficiaries who would otherwise receive the shares, and which tax paid assets have a value equal to the value of the shares at the taxpayer's death.

A post-mortem pipeline involves a taxpayer's estate[43] selling shares of a private corporation (the "first corporation") owned by the taxpayer at death (which shares have, as a result of the deemed disposition of the shares at the taxpayer's death, an ACB to the estate equal to the FMV of the shares at the taxpayer's death) to a newly incorporated private corporation ("Holdco") whose sole shareholder at the time of the sale is the estate, for consideration which includes a promissory note payable by Holdco to the estate (or shares of Holdco with a high ACB and PUC equal to the FMV of the transferred shares) in the amount of the high ACB of the transferred shares. Where the shares have not appreciated in value since the deceased's death[44], there will be no gain on the sale of the shares to Holdco, since the ACB of the shares is equal to their FMV following the deemed disposition of the shares at the taxpayer's death. The promissory note or the high PUC shares issued by Holdco create a "pipeline" to extract assets from the corporation without further tax cost to the estate. Following such sale and where Holdco is connected to the first corporation

42 See CRA Document no. 2016-0634551E5.

43 A post-mortem pipeline may in certain circumstances be implemented by the beneficiaries of an estate after the estate has distributed the shares of a corporation to the beneficiaries. See the CRA's ruling in Document no. 2020-0838951R3.

44 To the extent that the shares have appreciated in value since the taxpayer's death, the estate could effect a tax-deferred rollover under subsection 85(1) and receive shares of Holdco having a FMV equal to the appreciated value.

under subsection 186(4)[45] and to the extent that the first corporation does not receive a refund of RDTOH, the first corporation can pay a tax–free inter-corporate dividend, to the extent of the corporation's safe income attributable to the shares which are the subject of the dividend[46], to Holdco to fund the repayment of the promissory note, or the return to the estate of the high PUC of the Holdco shares, and with no additional tax to the estate.

Before implementing a post-mortem pipeline, the anti-avoidance provisions of section 84.1 and subsection 84(2) must be considered. The CRA has described the potential application of these anti-avoidance provisions as follows:

> A pipeline strategy is a post-mortem planning technique that is used to mitigate a form of double taxation exposure that can result at the shareholder level when a person owns shares of the capital stock of a private corporation with an accrued gain at the time of his/her death. When correctly implemented, the result of the pipeline strategy is that the extraction of the corporation's surplus is subject to taxation as a capital gain resulting from the application of the deemed disposition rules on death.
>
> In the course of undertaking a pipeline strategy, we would note that the anti-avoidance provisions of section 84.1 and subsection 84(2) must be examined. It is our view that these provisions, which have different requirements for application, target certain transactions that result in the extraction of corporate surplus otherwise than by way of a dividend treatment (traditionally known as "surplus stripping"). Furthermore, we believe that section 84.1 and subsection 84(2) are not in conflict and that the potential application of both provisions must be considered in the context of pipeline transactions.
>
> Subsection 84(2) would apply where funds or property of a corporation resident in Canada have at any time after March 31, 1977 been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares in its capital stock, on the winding-up, discontinuance or reorganization of its business. The result of the application of subsection 84(2) is that the particular corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount described in the remainder of the provision.
>
> Consequently, in the context of a series of transactions designed to implement a post-mortem pipeline strategy, some of the additional facts and circumstances that in our view could lead to the application of subsection 84(2) and warrant dividend treatment could include the following:
>
> > * The funds or property of the original corporation would be distributed to the estate in a short time frame following the death of the testator.
> >
> > * The nature of the underlying assets of the original corporation would be cash and the original corporation would have no activities or business ("cash corporation").
>
> Where such circumstances exist and where subsection 84(2) would apply resulting in dividend treatment on the distribution to the estate, we believe that double taxation at the shareholder level could still be mitigated with the implementation of the

45 Holdco would be connected with the first corporation under subsection 184(6) where following the transfer of the shares, (i) Holdco controls the first corporation, or (ii) Holdco owns more than 10% of shares of the first corporation having full voting rights under all circumstances and shares of the first corporation having a FMV of more than 10% of the FMV of all the issued shares of the first corporation.
46 See paragraph 55(2.1)(c).

subsection 164(6) capital loss carryback strategy, provided the conditions of that provision would apply in the particular facts and circumstances.[47]

Section 84.1 is an anti-surplus stripping provision designed to prevent the removal of after-tax income or retained earnings from a corporation as a tax–free return of capital rather than as taxable dividends. Section 84.1 applies to a transfer by a Canadian resident taxpayer (other than a corporation) of shares (the "subject shares") of one corporation (the "subject corporation") to another corporation (the "purchaser corporation") with which the taxpayer does not deal at arm's length, and where the subject corporation is connected to the purchaser corporation under subsection 186(4) immediately following the transfer, and in circumstances where the FMV of the non-share consideration issued by the purchaser corporation, if any, and the increase in the PUC of the shares of the purchaser corporation issued to the taxpayer as consideration (the "new shares") exceed the greater of, (i) the ACB (as adjusted for purposes of section 84.1) of the subject shares, and (ii) the PUC of the subject shares. For the purposes of section 84.1, the ACB of the subject shares is reduced in respect of both pre-1972 gains and any capital gains deduction previously claimed on the shares (or shares for which the shares were substituted) by the taxpayer or a person with whom the taxpayer did not deal at arm's length[48]. This adjusted ACB of the subject shares is sometimes called the "arm's length" ACB of the subject shares.

Where the above circumstances exist, paragraph 84.1(1)(a) reduces the PUC of the class(es) of new shares issued by the purchaser corporation as consideration by the resulting increase in the stated capital of the class(es) of all the new shares of the purchaser corporation issued as consideration less the excess, if any, of, (a) the greater of the PUC of the subject shares and the transferor's "arm's length" ACB of the subject shares in either case determined immediately before the disposition, over (b) the fair market value, immediately after the disposition, of any non-share consideration paid by the purchaser corporation for the subject shares. Where more than one class of shares is issued in a transaction to which section 84.1 applies, the PUC reduction is prorated over the classes of new shares that were issued on the transfer on the basis of the increase in the stated capital of each class of new shares issued.

Paragraph 84.1(1)(b) deems the purchaser corporation to have paid a dividend to the taxpayer transferor and the transferor to have received that dividend where the aggregate of the amount of the total increase in the PUC of all of the purchaser's new shares arising as a result of the issue of those new shares on the transfer and the FMV, determined immediately after the disposition, of any non-share consideration received by the transferor for the subject shares exceeds the total of, (a) the greater of the transferor's "arm's length" ACB of the subject shares and the PUC of the subject shares in either case determined immediately before the disposition, and (b) the total PUC reductions required to be made by the purchaser corporation under paragraph 84.1(1)(a), above.

Under subsection 84(2), where, "... funds or property of a corporation resident in Canada have ... been distributed or appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares ... on the winding-up, discontinuance or reorganization of its business ...", the holders of the class of shares are deemed to have received a dividend equal to the amount by which the FMV of the funds or property distributed or appropriated exceeds the amount by which the PUC of

47 Response to Question 23, CRA Roundtable, 2011 CTF Conference, CRA Document no. 2011-0426371C6.
48 See paragraphs 84.1(2)(a) and 84.1(2)(a.1).

the shares of that class is reduced on the distribution or appropriation.

Paragraph 88(1)(d.1) provides that subsection 84(2) does not apply to the winding-up of a subsidiary corporation into a parent corporation under subsection 88(1). Accordingly, subsection 84(2) should not apply where a post-mortem pipeline includes a winding-up under subsection 88(1) of the subsidiary corporation into Holdco.

Further and notwithstanding the CRA's comments at the 2011 Roundtable[49], there are various arguments why the CRA may be incorrect in its view that section 84.1 and subsection 84(2) may apply to a post-mortem pipeline which does not include a subsection 88(1) winding-up of the subsidiary corporation, which include the following:

(a) section 84.1 appears to expressly permit the extraction of "arm's length" ACB in the course of a typical post-mortem pipeline; and

(b) to the extent that subsection 84(2) applies only where assets have been distributed or appropriated "on the winding-up, discontinuance or reorganization of [the first corporation's] business", where the first corporation is not carrying on a business or, if it is carrying on a business, where the distribution of the corporation's assets does not occur on the winding-up, discontinuance or reorganization of that business, subsection 84(2) should not apply to the distribution.

In addition, it is arguable that the general anti-avoidance rule in subsection 245(1) (the "GAAR") should not apply to a typical post-mortem pipeline, and where the estate cannot be considered to be an "accommodation party" that has been inappropriately used to extract corporate assets following the death of a taxpayer.

Despite these arguments, the CRA has issued numerous advance tax rulings and technical interpretations in response to post-mortem pipelines undertaken by taxpayers in which it has stated that subsection 84(2) will apply to deem a dividend to have been paid in the course of a post-mortem pipeline if the funds or property of the first corporation are distributed to the estate less than one year after the death of the shareholder or if the corporation does not carry on any business or investment activity[50], and merely holds cash or near-cash assets.[51] In the CRA's view, there must be a cooling-off period between the transfer of shares of the first corporation held by the deceased, and the subsequent distribution of the first corporation's assets to the deceased's estate or beneficiaries.

Further, the decision of the Federal Court of Appeal in *MacDonald v. The Queen*[52] suggests that a typical post-mortem pipeline may attract the application of subsection 84(2). The Court in *MacDonald* considered a series of transactions implemented by a medical doctor and in respect of his professional corporation, and upon his emigration from Canada. The series of transactions, which resulted in the issuance to the doctor of a promissory note and the repayment, albeit indirectly, of that promissory note funded with an otherwise tax-free inter-corporate dividend, were similar to those which are commonly implemented in a post-mortem pipeline. The Minister had reassessed the doctor on the basis that subsection 84(2) applied to re-characterize the repayment of the promissory note as a dividend, or otherwise that the GAAR applied to re-characterize the repayment of the promissory note as a dividend. Although the Tax Court of Canada determined that neither subsection 84(2) nor the GAAR applied to the

49 See note 45, above.

50 The CRA views the earning income from property as a business for the purposes of subsection 84(2). See CRA Roundtable, 2012 Prairie Tax Conference, Q. 14, CRA Document no. 2012-0445341C6.

51 See, for example, CRA Document no. 2010-0389551R3, where a ruling request for a post-mortem pipeline involving an inactive company with only liquid assets was withdrawn.

52 2012 DTC 1145 (TCC), reversed 2013 FCA 110.

repayment of the promissory note to the doctor, the Federal Court of Appeal disagreed and reversed the Tax Court's decision, ruling that subsection 84(2) did apply to re-characterize the repayment of the promissory note as a dividend to the doctor.

With a view to addressing the potential application of the anti-avoidance provisions in section 84.1 and subsection 84(2), the CRA has issued a number of favourable advance income tax rulings[53] on post-mortem pipelines that included the following elements:

(a) the first corporation carries on a business[54] at the time of the transfer by the estate to Holdco of shares of the first corporation, and continues to carry on the business for a period of at least one year following such transfer;

(b) the first corporation is not amalgamated or wound–up into Holdco for at least one year following such transfer;

(c) the amount of the promissory note or high PUC shares of Holdco issued by Holdco to the estate as consideration for the transfer to Holdco of the estate's shares of the first corporation does not exceed the "arm's length" ACB of the estate's shares of the first corporation, and is or are repaid or redeemed in a series of installments following the first anniversary of the transfer of the shares.[55] The said repayment or redemption may be funded by the sale of the first corporation's assets, and so long as it otherwise continues to carry on its business; and

(d) during the one-year period following the transfer of the shares, each of the first corporation and Holdco may distribute its current year income to its shareholders in the ordinary course, and may also repay its debts and liabilities (other than the promissory note), including to its shareholders, and may fund such repayment with sales of its assets.

Where the above elements are present in a post-mortem pipeline, the CRA has stated that, (i) section 84.1 will not apply to deem the estate to have received a dividend from Holdco on the transfer of shares of the first corporation, (ii) subsection 84(2) will not apply to deem Holdco to have paid, and the estate to have received, a dividend on the issuance, repayment or redemption of the note or high PUC shares of Holdco issued by Holdco to the estate as consideration for the transferred shares of the first corporation, and (iii) the GAAR will not apply to re-determine the tax consequences of any of the transactions in the post-mortem pipeline.

The CRA has stated that the one-year waiting period common to the post-mortem pipelines contemplated in the CRA's favourable rulings is not a requirement to avoid the application of section 84.1, subsection 84(2), and the GAAR.[56] However, the one year waiting period is common to virtually all of the CRA's favourable

53 In its response to Question 23, CRA Roundtable, 2011 CTF Conference, CRA Document 2011-0426371C6 dated November 27, 2011, CRA identifies the following favourable rulings where it has concluded that subsection 84(2) would not apply to a proposed full or partial post-mortem pipeline: CRA Document nos. 2002-0154223, 2005-0142111R3, 2007-0237511R3, 2009-0346351R3, 2010-0377601R3, 2010-0388591R3 and 2011-0403031R3. See also CRA Document nos. 2012–0435131R3, 2012–0456221R3, 2012–0464501R3, 2013–0503611R3, 2013-0509251R3, 2014–0526361R3, 2014–0541261R3, 2014–0559481R3, 2019-0790001R3, 2019-0832601R3, 2019-0835131R3, 2020-0839401R3, 2019-0793281R3, 2019-0819191R3, 2019-0822951R3, and 2020-0842241C6.

54 The CRA has confirmed that business for this purpose can include the investing in securities. See CRA Document 2018-0767431R3.

55 See, however, CRA Document no. 2018-0789911R3 where the CRA accepted that upon the transfer by an estate of shares of a corporation to a new corporation, the estate could immediately receive cash in payment of the promissory note issued as consideration for the shares to fund income taxes resulting from the deemed disposition of the shares at the taxpayer's death.

56 See CRA Document no. 2006-0170641E5 dated June 29, 2006.

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rulings on post-mortem pipelines.

In light of the *McDonald* decision[57] and the CRA's statements and unfavourable rulings on post-mortem pipelines which did not include the above elements, in order to avoid audit risk, it is suggested that a post-mortem pipeline be implemented in a manner which includes the above elements.

The pipeline strategy can be implemented on its own, or can be combined with a section 88 bump described below.

Section 88 Bump

To the extent that the taxpayer realizes a capital gain on the deemed disposition of the shares of a private corporation immediately before the taxpayer's death, that gain is not eliminated in the course of a subsection 164(6) loss carryback, and the estate transfers its shares of the private corporation to a new corporation owned by the estate ("Holdco") in the course of implementing the pipeline strategy and takes back a promissory note or high PUC shares as consideration, paragraph 88(1)(d) permits, in certain circumstances, an increase, commonly referred to as a "bump", in the adjusted cost base of the first corporation's non-depreciable capital property on the winding-up of the first corporation into Holdco under subsection 88(1).

Generally, in order to complete a winding-up under subsection 88(1), a subsidiary corporation (the "first corporation" or the "subsidiary") and its parent corporation ("Holdco" or the "parent") must both be taxable Canadian corporations and the parent must own 90 percent or more of the issued shares of each class of the subsidiary immediately before the winding-up. Any remaining shares of the subsidiary must be owned by persons who deal at arm's length with the parent.

Where subsection 88(1) applies to a winding-up of a subsidiary, generally each property of the subsidiary is deemed to be disposed of for proceeds of disposition equal to its cost amount, and, subject to the parent making a designation under paragraph 88(1)(d) in respect of a property, acquired by the parent for its cost amount.[58]

In the case of the amalgamation of one or more wholly–owned subsidiary corporations[59] into a parent corporation, subsection 87(11) provides that the tax-deferred rollover rules in subsection 88(1) will apply to each capital property of the subsidiary corporation(s) where the following requirements of subsection 87(1) are met:

(a) immediately before the amalgamation each of the amalgamating corporations must the taxable Canadian corporations;
(b) all of the property (except amounts receivable from any predecessor corporation or shares of any predecessor corporation) of the predecessor corporations immediately before the amalgamation must become the property of the amalgamated corporation by virtue of the amalgamation;
(c) all of the liabilities (except amounts payable to any predecessor corporation) of the predecessor corporations immediately before the amalgamation must become liabilities of the amalgamated corporation by virtue of the amalgamation; and
(d) all of the shareholders (except any predecessor corporation) who owned shares of any predecessor corporation immediately before the amalgamation must receive shares of the amalgamated corporation

57 See also *Robillard (Estate) v. The Queen,* 2022 TCC 13, where the Tax Court of Canada questioned but ultimately applied the decision in *MacDonald* in determining that subsection 84(2) applied to a post-mortem pipeline where the first corporation was wound-up into Holdco and the pipeline promissory note issued to the estate was repaid in full within 8 months of the death of the taxpayer.

58 See subparagraphs 88(1)(a)(iii) and 88(1)(c)(ii).

59 "subsidiary wholly – owned corporation" is defined in subsection 248(1) as a "corporation all the issued share capital of which (except directors' qualifying shares) belongs the corporation to which it is a subsidiary".

because of the amalgamation.

Subsection 87(11) provides that the bump rules in subsection 88(1) which apply to a subsidiary's capital property on its winding-up also apply to a wholly-owned subsidiary's capital property where the wholly-owned subsidiary is amalgamated into its parent. Although the following discussion is limited to the bump rules in subsection 88(1) which apply on the winding-up of a corporation, it is equally applicable in the case of a vertical amalgamation.

In the course of a winding-up of a subsidiary under subsection 88(1), paragraphs 88(1)(c) and 88(1)(d) permit a parent to increase or "bump" the cost of each capital property, other than "ineligible property" [60], distributed to the parent above its cost amount. "Ineligible property" includes depreciable property. For the cost amount of an eligible property to be increased, the property must have been owned by the subsidiary continuously since the time that the parent last acquired control of the subsidiary until immediately before winding-up of the subsidiary. The property whose cost is to be increased must be designated in the parent's tax return for the taxation year that includes the date of the winding-up.

Under paragraph 88(1)(d), the aggregate amount (referred to as the "available bump room") by which the cost amounts of each eligible property owned by the subsidiary may be increased, or "bumped", is the portion of the amount by which the adjusted cost base to the parent of the subsidiary's shares immediately prior to the winding-up of the subsidiary (as determined under subparagraph 88(1)(b)(ii)) exceeds the total of:

(a) the amount by which the cost amount of all properties owned by the subsidiary immediately before the winding-up of the subsidiary, plus the amount of any money on hand, exceeds the total of the debts or other obligations to pay any amount of the subsidiary immediately before the winding-up and the reserves deducted in computing the subsidiary's income in the year of winding-up[61]; and

(b) the total of all taxable dividends, capital dividends, and life insurance capital dividends received on the shares by the parent[62].

In addition, the amount of the bump designated to each eligible property of the subsidiary cannot exceed the amount by which the fair market value of the eligible property at the time the parent last acquired control of the subsidiary exceeds the greater of the cost amount of the property to the subsidiary at the time the parent last acquired control of the subsidiary and the cost amount of the property to the subsidiary immediately before its winding-up.[63] Further, all of the amounts designated to each eligible property cannot exceed the total available bump room.[64]

60 See definition of "ineligible property" in subparagraphs 88(1)(c)(iii) to (vi). Examples of non-depreciable capital property are land and securities held for investment purposes. "Ineligible property" also includes, (i) property transferred to the parent on the winding-up where the transfer is part of a distribution (within the meaning of subsection 55(1)) made in the course of a reorganization in which a dividend was received to which subsection 55(2) would, but for paragraph 55(3)(b), apply (sometimes referred to as a butterfly transaction), (ii) property acquired by the subsidiary from the parent or a person or partnership that was not dealing at arm's length with the parent, and (iii) property distributed to the parent on the winding-up where as part of the series of transactions or events that includes the winding-up the parent acquires control of the subsidiary and any such property or substituted property is acquired by certain persons in the circumstances contemplated in subparagraph 88(1)(c)(vi) - this provision is sometimes referred to as the "bump denial rule". This rule is complicated, but generally applies if property distributed to the parent is acquired by any person, or any two or more persons, who individually or collectively own 10% or more of any class of shares of the subsidiary, and the person(s) who is or are acquiring the property is or are not related to the parent.

61 See subparagraph 88(1)(d)(i).
62 See subparagraph 88(1)(d)(i.1).
63 See subparagraph 88(1)(d)(ii).
64 See subparagraph 88(1)(d)(iii).

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The available bump room will be reduced by, (i) the payment of taxable or capital dividends by the subsidiary to the parent[65], and (ii) the increase in the cost of the subsidiary's property between the time the estate acquires control of the subsidiary (i.e. the time of the deceased taxpayer's death) and the time the estate transfers its shares of the subsidiary to Holdco, including as a result of the receipt by the subsidiary of the proceeds of insurance on the life of the deceased taxpayer.[66]

It is a condition of the "bump" in the cost of capital property that the parent must acquire control of the subsidiary. Paragraph 88(1)(d.2) provides that where control of a subsidiary is acquired from another person with whom the acquiror was not dealing at arm's length, the acquiror will be deemed to have acquired control when the person last acquired control. Paragraph 88(1)(d.2) also looks back through more than one non-arm's length transaction; thus, if a vendor was deemed under paragraph 88(1)(d.2) to have last acquired control of the subsidiary at a particular time that was prior to the time at which the vendor actually acquired control (because the vendor acquired control of the corporation from a person with whom the vendor did not deal at arm's length), the acquiror who does not deal at arm's length with the vendor will be deemed to have last acquired control at that particular time.

In the context of a post-mortem pipeline transaction, and except as set out in paragraph 88(1)(d.3), where a deceased taxpayer controlled a private corporation prior to the taxpayer's death, paragraph 88(1)(d.2) will generally deem the estate of the deceased taxpayer to have acquired control of the corporation at the time that the deceased taxpayer last acquired control, or was deemed by paragraph 88(1)(d.2) to have last acquired control, of the corporation. In the event that the estate subsequently transfers its shares of the corporation which it controls to a corporation (Holdco) with which it does not deal at arm's length, then the date that Holdco would be deemed by paragraph 88(1)(d.2) to have last acquired control of the first corporation would be the date that the deceased taxpayer acquired control of the first corporation.[67] Absent paragraph 88(1)(d.3), the available bump room would then be limited the cost amount to the deceased taxpayer of the taxpayer's shares of the first corporation and the fair market value of the first corporation's eligible property determined at the time the taxpayer acquired control of the first corporation.

However, in a post-mortem context, where control of a corporation is acquired by an estate because of an acquisition of shares of the corporation as a consequence of the death of an individual, paragraph 88(1)(d.3) deems the estate to have acquired control of the corporation immediately after the death from a person who deals at arm's length with the estate. Accordingly, where the estate transfers its shares of the first corporation to Holdco in the course of a pipeline transaction, and immediately following the transfer the estate and Holdco do not deal at arm's length, Holdco is deemed to have acquired control of the first corporation immediately after the death of the taxpayer from a person who deals at arm's length with Holdco.[68] This provision allows for the available bump room to be determined using the values of the deceased taxpayer's shares and the fair market value of the subsidiary's eligible property as at the date of the taxpayer's death.

For paragraph 88(1)(d.3) to apply, at least one share of the first corporation must be acquired as a consequence of the death of a taxpayer by the taxpayer's estate, the acquisition of the

65 See clauses 88(1)(d)(i.1)(A) and (B).
66 See clause 88(1)(d)(i)(A).
67 See CRA Document no. 9336515 dated August 29, 1994.
68 See CRA Document no. 2011-0391821E5.

share or shares by the estate must result in the acquisition of control of the first corporation by the estate, and the estate must transfer control of the first corporation to Holdco. The loss of voting entitlement on shares owned by the deceased taxpayer at the time of death will not in itself be sufficient to result in an acquisition of control by the taxpayer's estate - the acquisition of the taxpayer's shares by the estate must result in the estate's acquiring control of the first corporation. The bump under subsection 88(1) will not be available where the deceased taxpayer did not control the first corporation at the taxpayer's death.

An increase in the adjusted cost base of non-depreciable property distributed by the first corporation to Holdco contemplated in subsection 88(1) would reduce the capital gain which Holdco would otherwise realize on the disposition of its non-depreciable capital property upon its winding-up, or, if Holdco continues and is not wound up, upon the subsequent disposition of the non-depreciable capital property by Holdco.

Contact Us

If you have a Tax and Estate Planning matter and are in need of legal advice, please do not hesitate to contact **Greg Farano** at 416.865.6787 or via email at gfarano@grllp.com.

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