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Original version: As a matter of Tax - Is CRA digging in its heels on post-mortem pipeline planning?

As a matter of tax

Is CRA digging in its heels on post-mortem pipeline planning?

In the context of post-mortem estate planning for a deceased shareholder of an investment holding company, with capital gains rates lower than dividend rates, “pipeline” strategies which bring about capital gains treatment are currently in vogue.

The pipeline strategy is a post-mortem planning strategy designed to obtain capital gains treatment at death. To do this, subsection 70(5) is allowed to operate to trigger a deemed disposition of the shares at death. This triggers a capital gain and tax is paid accordingly. In order to avoid double taxation of any future extraction of assets from the company, planning is done to create a “pipeline” through which assets equal to the gain realized at death can be extracted from the corporation on a tax-free basis. Essentially, the adjusted cost base (“ACB”) is “incorporated” and converted into a note payable. Usually, this is accomplished by transferring the shares of the corporation to a new holding company in exchange for low paid up capital (“PUC”)/ACB shares of the holding company and a promissory note from the holding company equal to the ACB of the shares transferred. For more detailed information see our Tax Topic “Dealing with Private Company Shares at Death – Post-Mortem and Insurance Planning”(PDF).

Previously, several rulings were granted in specific fact situations involving post-mortem pipeline planning for holding companies that permitted these strategies to operate without the application of the “dividend-strip” provisions of subsection 84(2) of the Act. Recent CRA commentary has drawn into question the use of pipeline strategies in the investment holding company context. If the “dividend-strip” provisions were to apply, it would result in the recharacterization of the capital gain as a dividend. The original corporation would be deemed to have paid a dividend and thus the estate deemed to have received a dividend as a result of the sale of shares to the new Holdco in exchange for debt.

In October 2009 at the APFF conference (#2009-0326961C6), the fact pattern under consideration involved the death of a 100% shareholder of a company (“ACO”) holding only cash assets. A pipeline is undertaken. The question asked was trying to clarify if there is a specific time period which must be awaited before the winding-up occurs and if this would be relevant to the application of the dividend stripping provisions.

One of the concerns is that if there is a period that must be awaited that is longer than a year, and a dividend is deemed to occur, relieving provisions may not be able to operate to enable planning that would eliminate double tax. Where a dividend is deemed to occur after waiting a year, the capital loss arising from the deemed dividend could not be carried back against the capital gain of the deceased because this must be done within the first year of the estate pursuant to subsection 164(6) of the Act. This would leave the taxpayer and the estate in the untenable position of a capital gain in the terminal return and a potential deemed dividend resulting from subsection 84(2) after the estate’s year has passed.

In the APFF response, the CRA distinguished the facts of this situation from the prior rulings as follows:

> … Subsection 84(2) of the ITA requires that funds or property of a particular corporation must have been distributed or otherwise appropriated, in any manner whatever to or for the benefit

> of the shareholders on the winding-up, discontinuance or reorganization of its business or the particular corporation. In advanced rulings F2002-0154223 and F2005-0142111R3, the individual had ceased to be a shareholder of the particular corporation for a period of at least one year, before the receipt of the funds or the property on the winding-up, discontinuance or reorganization of its business of the particular corporation.
>
> In addition, the situation briefly described in the present question appears to us to defer (sic) from those described in the advanced rulings … among others, ACO does not appear to be carrying on a business prior to the death of the taxpayer and all of its assets consist of liquid assets. Consequently, and given that the present situation only summarily describes an hypothetical particular situation, we cannot provide any comments on the potential application of subsection 84(2) of the ITA …

This train of thought was confirmed at the 2010 Canadian Tax Foundation Conference in December 2010. More recently still, a ruling's request in a similar circumstance was denied (#2010-0389551R3). The fact pattern there involved post-mortem pipeline planning for a deceased 100% shareholder of a holding company that has "no investment activities" and that is "currently inactive" with "liquid assets (possibly only cash)."

Where does this leave us?

It may be that practitioners will have to seek rulings in each fact situation to assure proposed pipeline transactions will not be questioned as dividend-strips or, in the absence of this, to plan to withdraw funds only as needed over extended periods of time so as not to be viewed as being part of a "winding-up, discontinuance, or reorganization of the business" such that 84(2) would apply.

This problem will not impact taxpayers who have planned to receive dividends. Life insurance that is purchased to fund post-mortem redemption of shares uses capital dividends to the extent possible (i.e. the stop-loss rules would impose some limitations on the amount of capital dividends that can be used and still be able to carry back the capital loss generated to the terminal return of the deceased), to reduce tax on the deemed dividend on redemption.

These columns are current as of the time of writing, but are not updated for subsequent changes in legislation unless specifically noted

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