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TAX PLANNING FOR THE NON-SPECIALIST ADVISOR POST-MORTEM PLANNING FOR PRIVATE COMPANIES — RECONSIDERING OPTIONS FOR TRIGGERING CAPITAL GAINS — PART II

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Special thanks to Cy M. Fien, Fillmore Riley LLP, who after all these years continues to teach and mentor me, including providing invaluable technical and practical insights that have greatly improved this Series.

Private Corporation ("PC") Liquidation Planning on Death

Let's face it: post-mortem planning for clients with material interests in PCs is ridiculously complex!

There are so many options that tax professionals, advisors, and executors must take into consideration these days that it literally boggles the mind.

In Part I of this two-part series of articles (the "Series") we reviewed some of the primary income tax-related planning tools associated with tax planning on death, including some issues complicating the implementation of certain of these planning tools that are often employed in PC Liquidation (as defined herein) situations. In Part II of the Series, we will explore an alternative strategy, that I call "Spousal Rollover Liquidation Planning". This strategy may, in appropriate circumstances, offer a number of advantages over many of the primary post-mortem PC Liquidation planning tools, including being much more straightforward to implement, while still enjoying comparable tax results.

A Different Approach — Spousal Rollover Liquidation Planning

Instead of employing any of the Traditional Post-Mortem PC Planning Techniques¹ to effect post-mortem PC Liquidations², in specific circumstances, including those

¹ These techniques were defined in Part I of the Series to collectively refer to Subsection 164(6) Planning, Pipeline Planning, Paragraph 88(1)(d) Planning, and Hybrid Planning.

² Defined in Part I of the Series as the liquidation of an estate's interests in a PC, which in some situations may involve a partial or even the full liquidation of the properties held by the PC as well as the repurchase of the interests of the estate in the PC or even the wind-up of the PC.

described below, it may be possible to avoid many of the issues described in Part I of the Series and still enjoy comparable tax results using Spousal Rollover Liquidation Planning.

In particular, Spousal Rollover Liquidation Planning might be extremely useful in situations where there is a desire to implement a PC Liquidation, which is not otherwise precluded under the terms of a will, and the will contemplates a distribution by specific bequest or residue gift of all or portions of the estate, including PC shares, to a spouse³ or Spousal Trust⁴ and:

- (1) the assets required to fund the distribution can be satisfied out of existing PC tax pools (CDA, RDTOH, etc.);
- (2) a partial or complete PC Liquidation is desirable to fund the distribution, including on a full wind-up of the PC, **and** the PC Liquidation process will give rise to sufficient amounts of capital gains in the PC; or
- (3) a combination of (1) and (2) above.

In such situations, Spousal Rollover Liquidation Planning can be implemented by:

- (1) utilizing the Spousal Rollover to defer tax otherwise payable under subsection 70(5) in connection with the PC shares of a deceased person (a "Decedent");⁵ **and also**
- (2) implementing a PC Liquidation on a post-mortem basis that will be taxable to the spouse or Spousal Trust.

In these situations, the results of implementing Spousal Rollover Liquidation Planning should create a nearly fully integrated tax result akin to the tax results expected with Traditional Post-Mortem PC Planning Techniques.

When implementing Spousal Rollover Liquidation Planning, the possible choices as to how to implement the PC Liquidation are the same as would be available to any living individual taxpayer, including a trust, and might include, among others, the payment of ordinary taxable dividends, the payment of capital dividends, and the use of so called "surplus strip" transactions. In effect, instead of having to go through all of the complex Traditional Post-Mortem PC Planning Techniques to minimize potential multiple layers of post-mortem taxation, Spousal Rollover Liquidation Planning enables post-mortem planning to be implemented in a manner no different than other "ordinary" *inter vivos* planning.

When appropriate conditions exist for the implementation of Spousal Rollover Liquidation Planning, in addition to achieving comparable tax results to the Traditional Post-Mortem PC Planning Techniques, some of the other benefits of Spousal Rollover Liquidation Planning may include:

- (1) straight-forward implementation processes — in a liquidation situation there may be no need for costly and/or complex structuring;
- (2) the lack of urgent timelines — as may be the case in connection with Subsection 164(6) Planning;⁶
- (3) graduated rate estate ("GRE")⁷ qualification not being relevant — as is required with Subsection 164(6) Planning;
- (4) the ability to manage assets of an estate:
 - (a) during the estate's first fiscal period in the ordinary course of managing estate property, including, when appropriate, selling assets and realizing capital gains, without grinding capital losses in the estate's first taxation year pursuant to subsection 30(3.4) or (3.6); or
 - (b) without potentially restricting access to the Paragraph 88(1)(d) Bump;⁸ and
- (5) the avoidance of section 84.1 and/or section 212.1 — which could impact Pipeline Planning.

³ In the Series, any reference to the term "spouse" includes a reference to a common-law partner, as that term is defined in subsection 248(1) of the *Income Tax Act* (Canada) R.S.C. 1985, c.1 (5th Supp.), as amended (the "Act"). Unless otherwise provided all statutory references herein are to the Act.

⁴ Defined in Part I of the Series to refer to a qualifying trust for the benefit of a spouse in accordance with subsection 70(6).

⁵ It could be used to defer other gains as well but, in this Series, the focus is on PC shares.

⁶ To enjoy the Spousal Rollover, it will still be necessary to ensure that property, such as private corporation shares, vests with the spouse or Spousal Trust within 36 months (see subsection 70(6)).

⁷ As that term is defined in subsection 248(1).

⁸ In order for Paragraph 88(1)(d) Bump Planning to be effective, certain non-depreciable capital property ownership continuity rules in subparagraph 88(1)(d)(ii) must be met.

Some Issues Complicating Spousal Rollover Liquidation Planning

Spousal Rollover Liquidation Planning is not a panacea. To be effective, there needs to be a desire to implement a PC Liquidation — meaning there are factors (tax and/or non-tax) at play that favour a PC Liquidation and the realization of taxes on a current basis over the tax deferral otherwise available through a Spousal Rollover.

If the PC does not have or cannot create appropriate tax pools in a tax-efficient manner, then the cost of distributing property from the PC may be increased by the need for the PC to realize non-capital gains income, including recapture, which as part of the PC Liquidation process will require the PC to declare higher levels of tax-inefficient eligible and/or ineligible taxable dividends when compared to subsection 70(5) deemed capital gains. For example, when dealing with real estate holding corporations, which are often asset rich and cash poor, the immediate tax cost of a PC Liquidation may make Spousal Rollover Liquidation Planning impractical.⁹

Keep in mind that the PC Liquidation process itself may still require an examination of stop-loss rules in the Act in the event that the PC realizes capital losses as part of that process.¹⁰

If there are reasons why it is desirable to implement Spousal Rollover Liquidation Planning during the 36-month maximum GRE period (“GRE Period”)¹¹ and Spousal Rollover Liquidation Planning is implemented by indefeasibly vesting PC shares in the hands of the spouse or Spousal Trust, Spousal Rollover Liquidation Planning may result in a loss of GRE benefits since the income generated from those assets will from the time of implementation forward be earned by the spouse or Spousal Trust, rather than by the estate.

Spousal Rollover Liquidation Planning — Overcoming GRE Limitations?

As mentioned in Part I of the Series, to satisfy the requirements of the Spousal Rollover, a particular property of the Decedent (“Particular Property”)¹² must vest in a spouse or Spousal Trust within the GRE Period. Changes in value of the Particular Property owned by a Decedent between the time of a Decedent’s death and the time the Particular Property vests indefeasibly in the spouse or Spousal Trust should have no impact on the availability of the Spousal Rollover with respect to the Particular Property.

If, in accordance with the terms of a Decedent’s will that gives rise to an estate that is a GRE, the executors are able to wait to distribute PC shares (i.e., the Particular Property) to a spouse or Spousal Trust until shortly before the end of the GRE Period, then the income that is distributed to the estate during the GRE Period associated with the PC shares should remain eligible for taxation at GRE tax rates within the estate without impacting the Spousal Rollover.

Unfortunately, in some situations, including those noted earlier in Part I of the Series, it may be desirable to implement a PC Liquidation as quickly as possible. In these situations, at first glance, it would seem that the GRE benefits associated with income from the PC shares would be lost, but perhaps that doesn’t need to be the case.

In particular, if, subject to the terms of the Decedent’s will it is possible to:

- (1) implement the PC Liquidation in the estate but *not* repurchase the PC shares as part of the PC Liquidation process;
- (2) delay the distribution and vesting indefeasibly of the now nominal value PC shares to the spouse or Spousal Trust towards the end of the GRE Period; and
- (3) once the PC shares have vested indefeasibly in the spouse or Spousal Trust, the nominal value PC shares could, if desired, be repurchased or where appropriate, the PC could be wound-up,

then, subject to the discussion below, it would appear that there should be no loss of GRE benefits and, because the Particular Property (the PC shares) vests indefeasibly in the spouse or Spousal Trust within the GRE Period, the Spousal Rollover should still be available.

Rapid PC Liquidation — Maximizing GRE Benefits in Connection With Spousal Rollover Distribution Planning (“Rapid SRDP/GRE Plans”) — Additional Matters To Consider

Specific Bequests

In CRA Document No. 2001-0114795, dated December 18, 2001 (the “TI”), the CRA stated that “in the absence of any express indication to the contrary”, the use by an estate and/or distribution of income from property associated with

⁹ Sadly, this is an issue that also plagues the Traditional Post-Mortem PC Planning Techniques.

¹⁰ This stop-loss issue could be relevant to Traditional Post-Mortem PC Liquidation Planning Techniques as well.

¹¹ As set out in paragraph (a) of the GRE definition in subsection 248(1).

¹² There is no concept of “substituted property” in subsection 70(6).

the specific bequest would normally negate the ability to claim a Spousal Rollover to a Spousal Trust in connection with that property.

The logic of the CRA's reasoning in the TI appears to be based on a combination of two factors. According to the CRA, the beneficiary of a specific bequest of property will normally be the beneficial owner of the property as of the death of the Decedent. Consequently, where the beneficiary is a Spousal Trust, distributions of income or capital to the GRE would violate the provisions of subparagraph 70(6)(b)(ii), which requires no person other than a spouse obtain any income or capital from property of the Spousal Trust during the lifetime of the spouse.

If the CRA's views in the TI are correct, then where a will has been drafted so that the PC shares are distributed to a Spousal Trust by way of a specific bequest, it may not be possible to maximize GRE benefits in connection with Rapid SRDP/GRE Plans.

Unlike a Spousal Rollover to a Spousal Trust, a Spousal Rollover directly to a spouse contains no requirement similar to subparagraph 70(6)(b)(ii). Therefore, the TI should not impact a Spousal Rollover that is intended to be achieved via a direct specific bequest to a spouse.

However, unless the Decedent's will has been drafted in specific contemplation of Rapid SRDP/GRE Plans, then the implementation of such a plan is still unlikely to be possible. This is because, among other things, in the absence of advance planning, the distributions to the GRE would deprive the spouse or Spousal Trust of value otherwise attributable to the Particular Property (i.e., the PC Shares).

Residual Gifts

In the TI, the CRA reconfirmed the administrative position set out in paragraph 26(c) of IT-305R4 that the use by an estate and/or distribution of income from property associated with a residual gift does not preclude a Spousal Rollover to a Spousal Trust.¹³ For reasons described in the preceding section, the TI should not impact a Spousal Rollover that is intended to be achieved via a residual gift to a spouse. As a result, there do not appear to be any specific tax issues that would impact the ability to rapidly complete a Rapid SRDP/GRE Plan where a will has been drafted so that the PC shares are distributed to a spouse or Spousal Trust by way of a residual gift.

While will drafting issues will generally be far less problematic in respect of Rapid SRDP/GRE Plans involving residual gifts than those involving specific bequests, at a minimum, in residual gift situations, a Decedent's will should be drafted to ensure the executor has the power to convert part of the residue into cash by a distribution to the GRE and to distribute the shares *in specie* to the spouse or Spousal Trust.

GAAR

Advisors may want to consider whether the CRA could view Rapid SRDP/GRE Plans as creating unintended tax benefits such that it may challenge under the general anti-avoidance rule ("GAAR") in section 245.

¹³ As noted above, this technical issue should not impact a direct distribution.

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