Post-Mortem Planning: Update on Pipeline Planning

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Recent rulings, technical interpretations and Canada Revenue Agency (CRA) roundtable comments have brought into question the use of the pipeline planning strategy in post-mortem planning. At the CRA Roundtable held at the November 2011 Canadian Tax Foundation (CTF) Annual Conference, CRA officials were asked to again comment on its position relating to pipeline planning, specifically to provide some clarification on the timing issues that have been highlighted in recent prior commentary. The following is an overview of CRA´s past and present comments as well as some observations on its position.

The overall goal of post-mortem planning is to minimize the tax burden at death. When an individual owns shares of a private corporation, post-mortem planning can reduce or eliminate double taxation which may result from the deemed disposition of the shares at death and the tax liability on the ultimate distribution of the assets out of the corporation.

The pipeline strategy is a post-mortem strategy designed to obtain capital gains treatment at death on the shares of a private corporation, and "convert" the adjusted cost base (ACB) that arose on the deemed disposition of those shares into a loan from the corporation that can be repaid without incurring further tax. Usually this is accomplished by the estate transferring the shares of the corporation (now having a cost base equal to their fair market value due to the deemed disposition at death) to a new holding company in exchange for shares of the new holding company[1] and a promissory note from the holding company which is equal to the ACB of the shares transferred. With personal capital gains tax rates currently lower than dividend tax rates in most provinces;[2] the pipeline strategy has been very popular.

Recent commentary from the CRA has indicated that subsection 84(2) of the Income Tax Act (the "Act") may apply when pipeline planning is used. Subsection 84(2) applies where funds or property of a corporation resident in Canada have been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of the shareholders, on the winding up, discontinuance or reorganization of its business. The application of subsection 84(2) to a pipeline transaction would result in the debt repayment being characterized as a deemed dividend paid by the corporation to the estate, negating the tax benefits of this planning technique.

Prior to October 2009, the CRA had confirmed the desired tax attributes of pipeline planning in two rulings.[3] These ruling requests had asked for confirmation that the anti-avoidance provisions in section 84.1 (paid up capital reduction), subsection 84(2)(deemed dividend on winding up) and subsection 245(2)(general anti-avoidance rule) would not apply to post-mortem planning that included the pipeline strategy. The CRA indicated that these anti-avoidance provisions would not apply provided the estate did not windup Opco into Holdco for a period of at least one year. In a subsequent technical interpretation[4] the CRA stated that the one year waiting period was proposed by the taxpayer and was not a CRA requirement.

In October 2009 at the Association de Planification Fiscale et Financiere (APFF) conference[5] concerns were first raised that subsection 84(2) could apply to seemingly standard post-mortem pipeline planning. The question posed was trying to clarify if there was a specific time period which must be awaited before the winding-up occurs and if this would be relevant to whether subsection 84(2) would apply. The CRA repeated its view that the one year period is not a CRA requirement but was a fact presented by the taxpayer in the context of prior rulings. However, the CRA also stated that the one-year continuation of the business was a factor that helped it provide a favourable ruling on the non-application of subsection 84(2) in the 2002 and 2005 rulings. The CRA also stated that the situation presented in this question was different than the previous rulings because the company did not appear to be carrying on a business and all of the company´s assets were liquid.

Since the 2009 APFF Conference there have been comments made by the CRA at various conferences,[6] a few favourable ruling requests[7] and one situation where the ruling request was withdrawn due to the fact that the CRA was not prepared to provide a favourable ruling.[8] In one of the positive rulings the actual time period was less than one year before the distribution of the assets.[9] Also, although not “cash” companies, these companies were investment holding companies. The ruling request that was denied involved post-mortem planning for a deceased 100% shareholder of a holding company that had no investment activities and was currently inactive with liquid assets (possibly only cash).

The CRA commentary up to this point had caused some concern that pipeline planning may no longer work, particularly if the wind-up took place shortly after the formation of the holding company (or if the company´s assets were primarily liquid investments). The only way to guarantee the avoidance of double tax would be to obtain a ruling or to use subsection 164(6) loss carryback planning (resulting in dividend tax treatment), which is not as tax effective unless there is a sufficient capital dividend account (CDA) and/or refundable dividend tax on hand (RDTOH) balances.

Hoping for clarification, at the 2011 Annual CTF Conference, the CRA was again asked to clarify their position on pipeline planning. The question posed to the CRA was:

CRA has issued favourable rulings, but added timing conditions.

a) Where in the ITA do the rules and conditions come from?

b) Taxpayers are entitled to transperency and a level of certainty in the application of the ITA. Are amendments to the ITA to be expected?

The CRA responded as follows:

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

One concern with subsection 164(6) loss carryback planning is that it must be done within the first year of the estate. As a result, where a dividend is deemed to occur pursuant to subsection 84(2) after the first year of the estate, the capital loss arising from the deemed dividend could not be carried back against the capital gain of the deceased. This would leave the taxpayer and the estate in the untenable position of realizing a capital gain in the terminal return and a potential deemed dividend resulting from subsection 84(2) after the estate´s year has passed, resulting in double (and possibly triple) tax.

Even though the CRA has consistently commented that the requirement for the business to continue for one year was not a CRA requirement, when discussing previous favourable rulings in the 2011 CTF Roundable response, the CRA stated:

…in each case the taxpayers´ proposed transactions contemplated, amongst other things, the continuation of the original corporation´s business for a period of at least one year following the implementation of the pipeline structure, followed by a progressive distribution of the corporation´s assets over an additional period of time.

And consistent with past CRA responses, the CRA added at the end of its 2011 CTF Roundtable response that it will continue:

…to rule on the potential application of subsection 84(2) on a case-by-case basis, after a review of all the facts and circumstances surrounding each specific situation. We note that the CRA has neither the discretion nor the right to change the Act. Matters involving a change to the law and/or tax policy are the responsibility of the Department of Finance.

So where does this leave us? In the view of the author, the CRA´s response at the 2011 Annual CTF Foundation Conference helps draw a clearer line between what in CRA´s view is acceptable pipeline planning and what will be considered surplus stripping pursuant to subsection 84(2). “Good” pipeline planning would include a continuation of the original company (and the company´s business assets (i.e. not a “cash corporation”)) for a period of at least a year following the pipeline implementation, followed by a progressive distribution of the company´s assets over an additional time period. However, requesting a ruling will still be the only way to assure that pipeline transactions will not be subject to a deemed dividend under subsection 84(2).

Why does this matter for insurance advisors? As noted above, avoidance of double tax is possible through the use of subsection 164(6) loss carryback planning (resulting in dividend treatment). Where sufficient CDA is created with the use of life insurance, planning for dividends can result in the elimination of double tax and be even more tax efficient than pipeline planning. With the recent uncertainty around pipeline planning, clients may wish to “hedge their bets” by planning to receive dividends and make the receipt of dividends more tax efficient by purchasing life insurance to enable the receipt of tax-free capital dividends.

About the Author

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Endnotes

[1] These shares would have nominal paid-up capital and ACB.

[2] Alberta is the only province with a dividend tax rate lower than the capital gains rate. For 2012 Alberta´s eligible dividend rate is 19.29% and its capital gains rate is 19.5%. (Non-eligible dividend rate is 27.71%.)

[3] 2002-0154223, 2005-0142111R3.

[4] 2006-0170641E5.

[5] 2009-0326961C6.

[6] 2010 CTF Annual Conference CRA Roundtable and 2011 Society of Tax and Estate Practitioners (“STEP”) Conference CRA Roundtable (2011-0401861C6).

[7] 2010-0377601R3, 2010-388591R3, and 2011-0403031R3.

[8] 2010-0389551R3.

[9] This information was provided by the tax professional who received the ruling on behalf of their client and was not part of the stated facts as published in the rulings document.