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PIPELINE POST MORTEM STRATEGY

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KEY TAKEAWAY: CRA allows the immediate receipt of cash from a pipeline post mortem strategy to fund taxes due at death - CRA document 2018-0789911R3, January 1, 2019

When shareholders die, subsection 70(5) of the Income Tax Act (ITA) deems them to have disposed of all the shares in their corporations for fair market value immediately before death. For a successful company, the deemed disposition often results in a significant tax liability because the shares' FMV can greatly exceed the shares' adjusted cost base (ACB). For many years, the Canada Revenue Agency (CRA) has accepted that an estate may use the post mortem pipeline technique to distribute a company's surplus.

The deemed disposition moves the deceased shareholder's shares to their estate. Unlike the shareholder, the estate's ACB in the shares will be equal to the shares' FMV immediately before death (paragraph 70(5)(b)of the ITA). The CRA lets an estate dispose of a testator's shares to a new corporation, and to receive, in exchange, a promissory note for a sum equal to the fair market value (FMV) of those shares at the time of death. An estate consequently has access to the surpluses of the company of which the testator was a shareholder at the time of death, without any tax burden other than that triggered by the capital gain on the deemed disposition upon death. Absent the pipeline technique, the corporate surplus could only be distributed to surviving shareholders as more heavily taxed dividends.

The CRA generally agrees to use of the pipeline strategy with two conditions:

(1) repayment of the note cannot begin earlier than one year after the note's issuance, and

(2) the repayment must be spread over several months (see CRA Document Nos. 2018-0748381C6, May 29, 2018; 2018-0777441R3, 2018; 2018-0767431R3, 2018; and 2018-0754531R3, 2019, 2019-0824211R3, 2019-083260R3, 2020-0839401R3).

In a recent advance income tax ruling (CRA Document No. 2018-0789911R3, 2019), the CRA changed its longstanding position, and accepted that upon the sale of shares to a new company an estate could immediately receive cash directly from the surpluses of the company in the testator's possession to pay income taxes resulting from the application of subsection 70(5) of the ITA.

This ruling will give estates relatively quick access to the cash they need to pay the income taxes triggered by the testator's death. The CRA's earlier position made things difficult for executors, who had to wait at least a year before receiving the amounts generated from the pipeline. The CRA went a step further and allowed the estate to receive a partial payment on the note before the first anniversary without triggering subsection 84(2) of the ITA (which would deem the payment to be a dividend, as discussed below).

The one-year time limit is not based on legislation or even on jurisprudence, but gives the CRA assurance when it issues advance rulings. The one-year time limit and progressive repayment schedule usually required as a condition of a favourable ruling reduces the risk of a subsection 84(2) assessment.

The CRA has identified the quick payment of a target company's surplus to the estate, shortly after death, as one of the two factors that could trigger the application of subsection 84(2); the other is the company's status as a "cash corporation," meaning that it has only cash assets and no activities or business (see CRA documents 2011-0401861C6, June 2, 2011, and 2018-0748381C6, May 29, 2018).

This CRA's position in the advance ruling represents a recognition that pipeline transactions don't always result in a substantial change to the business activities of the companies involved, and that such a short time limit isn't always required to confirm that fact. The CRA now seems to be modifying its position if the early payment is used by the estate to pay taxes.

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