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FEDERAL TAX RULES GOVERNING INTERGENERATIONAL TRANSFERS OF CAPITAL ASSETS

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TABLE OF CONTENTS

Page

INTRODUCTION 1

THE TAX TREATMENT OF CAPITAL TRANSFERS 1

INHERITANCE AND DEEMED DISPOSITION 4

THE CAPITAL GAINS EXEMPTION 4

OTHER MEANS OF MINIMIZING CAPITAL GAINS TAXATION UPON DEATH 5

A. Death Benefit 5

B. Life Insurance 5

C. Estate Freeze 6

D. Testamentary Trust 6

E. Registered Retirement Savings Plan (RRSP) Contributions After Death 7

F. Charitable Contributions 7

CONCLUSION 9

SELECTED REFERENCES 9

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FEDERAL TAX RULES GOVERNING INTERGENERATIONAL TRANSFERS OF CAPITAL ASSETS

INTRODUCTION

The Canadian population is aging. Data from the 2001 Census show that the median age[(1)] in Canada was 37.6 years in 2001, up from 35.3 years at the time of the last census in 1996. This change represents the biggest census-to-census increase in a century.[(2)]

Moreover, the Canadian population aged 45 to 64 increased 36% between 1991 and 2001, due to the entry of the baby boomers into this group. As a result, Canada's working-age population has become more dominated by older individuals. As these individuals approach retirement age, many will start looking for ways they can help their families when they are gone without incurring large tax liabilities. This paper reviews some of the provisions in the *Income Tax Act* that deal with the transfer of capital assets between family members, and ways individuals can use these provisions to reduce their tax bill.

THE TAX TREATMENT OF CAPITAL TRANSFERS

Generally speaking, a transfer of capital property[(3)] to a family member is taxed as if it were a market transaction, regardless of whether the transfer is done as a gift or as a sale. In other words, transfers are taxed *as if* they were sold for what they could obtain at their "fair market value" (FMV) price. This situation is known as a "deemed disposition." As a result, the

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(1) Median age is the point where exactly one-half of the population is older, and the other half is younger.

(2) A decline in the number of births since 1991 is a major factor behind both the record-low growth in population between 1996 and 2001 and the record increase in median age. For more information on the 2001 Census, see http://www12.statcan.ca/english/census01/release/index.cfm.

(3) Capital property includes depreciable property and any property that, if sold, would result in a capital gain or capital loss. Examples include homes, cottages, stocks and bonds, as well as land, buildings and equipment used in a business or rental operation.

transferor must include in his or her income any capital gains or capital losses arising from such transfers (the aggregate value of the property transferred is not taxed), just as he or she would if the property were being sold to a non-family member.[(4)]

There are, however, two exceptions to this rule. First, a transferor can roll over capital assets to a spouse and avoid capital gains taxes until the spouse, in turn, either dies or sells the assets.[(5)] This exception stems from the fact that, in this instance, the *Income Tax Act* (ITA) considers a married couple to be a single economic unit.[(6)]

Second, rollover provisions also exist to encourage the children of farmers and commercial woodlot owners to take over the family business. Parents can transfer their farming business to their children without triggering a capital gain by, for example, giving them the farm outright or by selling it to them at cost.[(7)] The rollover provisions also allow parents to transfer the farm by selling it to their children for a profit, thus incurring a capital gain of their choosing, within certain limits.[(8)]

The spousal and farm/woodlot rollover provisions apply both while the transferor is living (*inter-vivos* transfers) and after death (testamentary transfers). Table 1 presents the rollover provisions for transfers to spouses as well as for transfers of farms and commercial woodlots to children.

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(4) Specifically, individuals must include one-half of the capital gain in their income. The capital gains inclusion rate was reduced to 50% from 75% in *Budget 2000* and the *Fall Economic Statement and Budget Update 2000*.

(5) Note that, for spousal transfers, the *Income Tax Act* (ITA) anti-avoidance rules make the transferor liable for any income generated by the subsequent sale of property transferred to a spouse, unless the property was originally transferred to the spouse at fair market value. For a discussion, see Claire Young, "What's Sex Got to Do With It? Tax and the 'Family,'" Law Commission of Canada, Ottawa, 15 May 2000, p. 44, available at http://www.lcc.gc.ca/en/themes/pr/cpra/young/young.pdf.

(6) Canada's federal system of taxation is primarily based on the principle of individual taxation, not the taxation of "economic units" such as the family. Young (see footnote 5) calls the rollover provision a "pragmatic" exception to the rule because it absolves the Canada Customs and Revenue Agency (CCRA) of the responsibility for tracking exchanges between spouses, which normally occur informally outside of markets.

(7) In such circumstances, the CCRA treats transfers as if the deemed disposition price were set at the adjusted-cost base (ACB), i.e., the original purchase price of the capital asset plus any applicable costs such as legal fees, commissions and expenses incurred in upgrading the asset.

(8) The maximum capital gain varies according to the fair market value of the asset. In other words, the deemed disposition price cannot be more than its FMV. The capital gain will be the difference between the chosen price (up to the FMV) and the adjusted-cost base. Rules that achieve the same effect for capital losses are applied for capital assets when the FMV is less than the original purchase cost.

Table 1: Comparing the Tax Costs of Transfers, *Inter-Vivos* and Testamentary

	Transfers of Non-Farm Capital Assets to a Non-Family Member or Family Member Other than a Spouse	Transfers of Capital Assets to a Spouse	Transfers of Farm Property to a Child	Transfers of a Commercial Woodlot to a Child
Relevant section or subsections of *Income Tax Act*	*Inter-Vivos*: 69 *Testamentary:* 70(5)	*Inter-Vivos*: 70(6), 73(1) *Testamentary:* 70(6)	*Inter-Vivos:* 73(3) *Testamentary:* 70(9)	*Inter-Vivos:* 73(3) *Testamentary:* 70(9)
Tax consequences	Deemed realization at fair market value with full tax consequences.	Deemed realization but tax-free rollover until final disposition by spouse. The transferor, if still alive, is eligible for any tax liabilities arising from this subsequent sale.	No capital gain if the capital asset is transferred as a gift or sold for its adjusted-cost base (ACB). A capital gain is triggered if sold for more than its ACB. The maximum capital gain is determined by the asset's fair market value.	No capital gain if the capital asset is transferred as a gift or sold for its adjusted-cost base (ACB). A capital gain is triggered if sold for more than its ACB. The maximum capital gain is determined by the asset's fair market value.
Conditions	All capital assets are subject to tax, except for farm-related assets.	No restrictions.	Applies only to property used for farming on a regular and continuous basis.	Applies to commercial woodlots where donors are "engaged" as set out in their forest management plan.
Eligible transferees	Everyone, except spouses and transfers of farm property (including commercial woodlots) to children.	Spouses, including common-law partners and spousal trusts. Also applies to former spouse or common-law partner in the case of a divorce or similar breakdown in the relationship.	Children, including a child born in or outside of a marriage, a spouse of a child, a stepchild, an adopted child, a grandchild, a great-grandchild and a person adopted-in-fact.	Children, including a child born in or outside of a marriage, a spouse of a child, a stepchild, an adopted child, a grandchild, a great-grandchild and a person adopted-in-fact.
Eligible capital property	All capital assets, except farm property and commercial woodlots.	All kinds of capital assets/property.	Land, capital equipment, shares and agricultural quota located in Canada.	Land, capital equipment, shares and agricultural quota located in Canada.
Type of transfer	Gift or sale, including sales at or below fair market value.	Gift or sale, including sales at or below fair market value.	Gift or sale, including sales at or below fair market value.	Gift or sale, including sales at or below fair market value.
Land-use requirements after transfer	No.	No.	No.	No.
Canadian citizenship requirement	No.	Yes, for both parties.	Yes, for recipient but not for transferor.	Yes, for recipient but not for transferor.
Special provisions	None.	Transferor can elect out of rollover provision.	Transferor can elect to specify a price (within certain limits) such that a capital gain or loss is triggered. Should the child-recipient die, the capital asset can be rolled over back to the parent.	Transferor can elect to specify a price (within certain limits) such that a capital gain or loss is triggered. Should the child-recipient die, the capital asset can be rolled over back to the parent.

Source: Library of Parliament.

INHERITANCE AND DEEMED DISPOSITION

Canada is one of the few developed countries without an inheritance tax on the aggregate value of assets transferred to a beneficiary at death (although the deemed disposition rule can be seen as at least partly fulfilling that function, in that it requires the deceased's estate to pay tax on accrued capital gains at the time of death). This absence of an inheritance tax is, however, a relatively recent phenomenon. The federal government introduced an inheritance tax in 1941 as part of its effort to finance the war. In the 1970s, the federal government ceded its inheritance tax to the provinces, which soon found that the tax was not feasible for practical reasons.(9) In the intervening years, there have been periodic proposals to reintroduce an inheritance tax at the federal level. In 1993, for example, the Ontario Fair Tax Commission noted that while a provincial inheritance tax was still not feasible, a federal inheritance tax was.

Other tax experts have disputed this conclusion, arguing that the introduction of an inheritance tax could be perceived as double taxation because of the deemed disposition rule. Still others have suggested that adding an inheritance tax would not, in fact, constitute double taxation because the deemed disposition rule is only a "catch-up" for taxes forgone while the decedent owned the property.(10) Regardless, "the argument against double taxation (real or perceived) is seen by most experienced practitioners as extremely strong."(11)

THE CAPITAL GAINS EXEMPTION

Owners of small businesses can also transfer capital assets to family members and avoid paying capital gains taxes by means of the $500,000 capital gains exemption for the sale of qualified small business shares.(12) Thus, a small business person could, for example, sell the

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(9) These practical reasons include the difficulty in taxing individuals with property and/or beneficiaries outside of the province, as well as the fact that Alberta opted not to introduce an inheritance tax after the federal government ceded the tax room. Alberta's decision put pressure on other provinces to abolish their respective inheritance taxes, especially as many wealthy individuals made clear their intention of moving to Alberta if those taxes were not repealed. Quebec was the last province to abolish its inheritance tax in 1986.

(10) Some also argue that, even if one accepts the double taxation argument, the problem could be avoided by either crediting the tax bill from the deemed disposition against any monies owed on the inheritance tax or by allowing the carryover of the cost basis from the decedent to his or her beneficiaries.

(11) Wolfe D. Goodman, "Death Taxes in Canada, in the Past and in the Possible Future," *Canadian Tax Journal*, Vol. 43, No. 5, 1995, pp. 1360-1376.

(12) Note that the $500,000 capital gains exemption yields a maximum deduction of $250,000 given the current 50% inclusion rate (see footnote 4).

family business to one of his or her offspring without incurring a tax liability, provided the resulting capital gain was $500,000 or less.(13) In that sense, the exemption acts almost like a rollover provision to the extent that each successive generation benefits from the $500,000 exemption, provided that the business does not increase in value beyond that threshold in any single generation. The *Income Tax Act* contains a similar provision for farmers.

OTHER MEANS OF MINIMIZING CAPITAL GAINS TAXATION UPON DEATH

There are a number of other ways in which these and other provisions in the *Income Tax Act* can be used either together or individually to minimize the tax bill of the decedent's estate, even with the deemed disposition rule. Some of these methods are discussed below.(14)

A. Death Benefit

Under the *Income Tax Act*, an individual is entitled to receive up to $10,000 tax-free from the employer of a deceased person provided the death benefit, which presumably would have been negotiated between the deceased, the deceased's union, or some other representative and the employer, is paid in recognition of the deceased's years of service.(15) Note that the $10,000 exemption is a total exemption and must be shared by all those who receive some portion of the death benefit.

B. Life Insurance

Income transferred to a family member from a life insurance policy is exempt from taxation.(16) Tax planners often advise their clients to purchase life insurance sufficient to at least pay off taxes (because of the deemed disposition rule) or any other liabilities incurred at

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(13) The $500,000 capital gains exemption applies regardless of who purchases the qualified small business shares, i.e., regardless of whether or not the purchaser is a family member.

(14) The discussion in this section draws heavily on Jerry White, ed., *Death & Taxes: Beating One of the Two Certainties in Life*, Warwick Publishing, Toronto, 1998.

(15) For a detailed discussion of how the death benefit works, see the CCRA Interpretative Bulletin IT-508R, available at: http://www.ccra-adrc.gc.ca/E/pub/tp/it508r/it508r-e.html.

(16) This is somewhat counter-intuitive, since an insurance policy can be seen as a form of investment. Boadway and Kitchen, for example, argue that the non-taxation of insurance income "violates the principles of equity and neutrality." See Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, Canadian Tax Foundation, Toronto, 1999, p. 157.

the time of death. As one chartered accountant put it, "[l]ife insurance can make up the difference between what you have accumulated and what would be required in the event of a disability or premature death. It provides tax-free funds so that your dependents will be able to maintain your desired standard of living, provide for educational needs, pay off the home mortgage, and so on."(17)

C. Estate Freeze

An estate freeze is a tax planning strategy that locks in or "freezes" the value of an asset today so that any future appreciation in value is passed on to the beneficiary chosen by the deceased. For example, a small business owner could freeze the value of his or her business by transferring ownership to a new corporation. The transfer triggers a capital gain, which can be sheltered with the $500,000 capital gains exemption for small business shares discussed earlier. In return for transferring the shares, the small business owner would likely opt to receive preferred shares in the new company and issue common shares to his or her children or some other individual(s) of his or her choosing. All future growth in the value of the business, and the resulting capital gains, would accrue to the children or the individual(s) who received the common shares.

D. Testamentary Trust

By setting up a testamentary trust, an individual can effectively create "another taxpayer" insofar as the *Income Tax Act* is concerned. This provision allows the deceased and his or her beneficiaries to reduce the total tax bill by splitting income between the trust and the beneficiaries. To illustrate this situation, consider two scenarios.(18) In scenario A, John Doe's will leaves the proceeds from his insurance policy ($500,000) to his son Frank, who earns about $60,000 a year. In scenario B, John Doe's will puts the funds into a trust whose sole beneficiary is also Frank. In both scenarios, assume that the money is invested in bonds that earn 10% a year, or $50,000 in interest income that is received by Frank. In scenario A, Frank's taxable income for the year is $110,000, i.e., $60,000 from his job and $50,000 from his bond

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(17) Carmen Da Silva, "Life Insurance as a Tool for Estate Planning," in White (1998), p. 57.

(18) This example is nearly identical to one used by Tim Cestnick in his article "Taxed to Death – and After," which appears as Chapter Two in White (1998).

investment. Assuming no deductions and no tax credits, in 2003, his total federal tax bill would be $24,184.(19)

In scenario B, and again assuming no deductions and no tax credits, Frank's taxable income is the $60,000 he earns from his job. Because his trust is viewed as a separate legal entity, the $50,000 in interest income from Frank's bond investment is taxed separately and, as such, at a lower rate. As a result, Frank's total tax bill – including taxes paid by his trust – is $20,338.(20)

E. Registered Retirement Savings Plan (RRSP) Contributions After Death

Individuals can direct the executor of their estate to continue contributing to a spousal RRSP – an RRSP where one spouse makes contributions on behalf of another – after their death. By so doing, the deceased's estate can use the RRSP deduction to lessen any tax owed from the deemed disposition rule while transferring a tax-deferred investment to his or her spouse.

To be eligible for post-death contributions to a spousal RRSP, the deceased must have RRSP contribution room available at the time of death. The law also requires that the beneficiary spouse be less than 69 years old on 31 December of the year of the deceased's death.

F. Charitable Contributions

In the last half of the 1990s, the federal government introduced a number of tax measures aimed at increasing donations to registered charities by individuals and corporations. The new measures included an increase in the amount that an individual can donate to a charity while still claiming a tax credit. As of 1996, individuals can receive tax credits for donations worth up to 75% of their net income, an increase from 20% in previous years. Beginning in 1997, the government set the capital gains inclusion rate on donations of publicly traded

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(19) This figure was arrived at by applying the federal government's four marginal tax rates, i.e., 16% on the first $32,183 worth of income, 22% on income between $32,183 and $64,368, 26% on amounts between $64,368 and $104,648 inclusively, and 29% on income above this last threshold.

(20) The $50,000 held in the trust is taxed at a 16% rate on the first $32,183 and at a 22% rate on the next $32,185. In scenario A, most of this interest income is taxed at the 26% marginal rate, with some taxed at 22% (the difference between the upper end of the second tax bracket, i.e., $64,368, and Frank's salary of $60,000) and some taxed at 29% (the difference between $110,000 and $104,648).

securities to charities at one-half the inclusion rate for other types of capital gains.[(21)] A similar measure was introduced for donations of ecologically sensitive lands in *Budget 2000*. Consequently, in 2001 and beyond, donors have to include only 25% of any capital gains resulting from the donation of publicly traded securities or ecologically sensitive lands to a charity,[(22)] rather than the 50% rate that would have applied had the measures not been implemented.

There are a number of ways these rules can be used to reduce the tax bill of a deceased person's estate. To illustrate one such method,[(23)] imagine that John Doe's will transfers $25,000 worth of shares (at the time of death) in ABC corporation to his son Frank. Assume that John Doe paid $10,000 for the shares two years earlier. In the absence of any further action, the deemed disposition rule would trigger a capital gain of $15,000 and a federal tax bill of $2,175, assuming John Doe is in the highest marginal tax bracket of 29%. Now assume that, instead of transferring the shares to his son Frank, John Doe's will instructed his executor to donate the ABC shares to a registered charity. The lower capital gains inclusion rate on donations of publicly traded securities means that rather than paying $2,175 in capital gains taxes, John Doe's estate pays $1,087.50. Moreover, John Doe's estate generates a federal tax credit worth $4,324 that can be used to offset the estate's tax bill.[(24)]

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(21) Special rules also exist for donations of cultural property to Canadian institutions and public authorities. For example, the donor does not pay tax on any capital gains resulting from a gift of this kind, nor are there any limitations on the size of the resulting tax credit vis-à-vis net income.

(22) The capital gain (or loss) for donations of securities is calculated by comparing the adjusted-cost base (essentially the cost of the asset) with the fair market value at the time the donation is made. Note also that the ITA allows a donor to specify ("designate") the market value so long as this designated amount is less than the fair market value but more than the adjusted-cost base. The capital gain calculations for ecologically sensitive lands are somewhat more complex. Here, the amount of the gift is the greater of the market value of the gift or the amount of the reduction in the land's market value as a result of making the gift. Claims on this kind of gift are not limited to a percentage of the donor's net income.

(23) Other methods include using charitable remainder trusts, life insurance policies and filing as many tax returns as legally possible at the time of death. For details on these and other more complex approaches to reducing the tax bill of a deceased person's estate, see White (1998).

(24) The federal tax credit on charitable donations entitles donors to a tax credit of 16% on the first $200 worth of donations and 29% on donations above this amount.

CONCLUSION

As the population ages, an increasing number of Canadians will likely start thinking about how they can best ensure that their assets are transferred to family members with the least tax consequences. Canada is one of the few developed countries that does not have a tax on the total value of assets transferred from one generation to the next. That said, the deemed disposition rule goes at least part of the way towards achieving an inheritance tax, by ensuring that any accumulated capital gains at death are taxed as if they were sold in the market.

The *Income Tax Act* provides some exceptions to the deemed disposition rule for transfers of assets between spouses and between generations of farmers and commercial woodlot owners. Capital gains exemptions on sales of qualified small business shares and farms also help ease the tax consequences of intergenerational transfers. In those cases where the deemed disposition rule cannot be avoided, individuals can use a number of other tax provisions to minimize their estate's tax bill.

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