

**The Joint Committee on Taxation of
The Canadian Bar Association and
The Canadian Institute of Chartered Accountants**

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Mr. Brian Ernewein
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Floor, East Tower,
140 O'Connor Street,
Ottawa, Ontario
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Dear Mr. Ernewein:

Re: Estate Loss Carryback Exception--Proposed Subsection 40(3.61)

We are pleased to provide you with our comments related to proposed subsection 40(3.61) of the Income Tax Act (Canada) (the "Act") for your consideration and review. While the new rule, contained in Bill C-33, is certainly welcome, in our view it is too narrow in its application.

Background

We understand that this rule is being introduced in order to provide relief from the stop-loss rule in subsection 40(3.6) in certain situations involving an estate where subsection 40(3.6) could otherwise apply to deny inappropriately a capital loss as a consequence of the proposed amendments to section 251.1 of the Act related to affiliated persons and trusts. Although the new rule will provide relief for estates, it will unfortunately not provide relief in other situations for which, from a tax policy perspective, it is just as appropriate that relief be available. These include situations where a spouse dies leaving shares to a trust that qualifies as a "spousal trust" under subsection 70(6) of the Act, and situations involving "alter ego trusts" and "joint spousal or common-law partner trusts" as those terms are defined in subsection 248(1) of the Act.

Estate Spousal Trust Example

Consider the following example. An individual, “Mr. X”, owns the preferred shares of a corporation (“Holdco”) and the common shares of Holdco are held by Mr. X’s only child. The voting rights of the Holdco preferred shares give Mr. X voting control of Holdco. This structure was created through a typical “estate freeze” undertaken a number of years ago. Mr. X’s will provides that on his death, if his spouse (Mrs. X) survives him, the preferred shares of Holdco are to be transferred to a “spousal trust” that satisfies the requirements of subsection 70(6). Mr. X’s child is the only other beneficiary of the spousal trust. If Mr. X survives his wife then his will provides that his child will be the beneficiary of his estate.

If Mr. X’s spouse predeceases him then proposed subsection 40(3.61) of the Act should apply as intended to allow the executors of Mr. X’s estate to undertake post mortem transactions whereby the preferred shares of Holdco would be redeemed and the resulting capital loss could be carried back pursuant to subsection 164(6) of the Act to Mr. X’s final personal income tax return. The capital loss could then be applied against the capital gain that would arise from the deemed disposition of the preferred shares held by Mr. X under subsection 70(5).

If on the other hand Mr. X is survived by his spouse and Mr. X’s preferred shares of Holdco are transferred to the spousal trust, then the estate plan would call for the preferred shares to be redeemed in the year in which Mrs. X dies or in any of the subsequent three taxation years. The resulting capital loss realized by the spousal trust would be applied against the deemed capital gain realized by the spousal trust on the shares of Holdco in the year of Mrs. X’s death because of the application of paragraph 104(4)(a) of the Act. If the shares are disposed of subsequent to the taxation year in which Mrs. X dies, the capital loss would be carried back to that year pursuant to paragraph 111(1)(b) of the Act.

Because of the proposed amendments to subsections 251.1(1) and (3) of the Act, the capital loss that would arise from the redemption of the preferred shares held by the spousal trust would technically be denied. This is because Mr. X’s child would control Holdco immediately after the redemption of the preferred shares and would therefore be affiliated with Holdco and the child would also be affiliated with the spousal trust because of proposed subparagraph 251.1(1)(g)(i). Therefore, the spousal trust would be affiliated with Holdco pursuant to proposed subparagraph 251.1(1)(g)(ii) immediately after the redemption and subsection 40(3.6) would apply to deny the capital loss.

Proposed Subsection 40(3.61) Too Narrow in its Application

In our view, the relief from subsections 40(3.4) and (3.6) provided by proposed subsection 40(3.61) should be available not only for estates, but also for certain trusts used in connection with estate plans, namely spousal trusts, alter ego trusts and joint spousal trusts. Such trusts can be regarded as analogous to estates. They are an alternative vehicle for dealing with property on the death of a taxpayer. From a tax policy perspective, we see no reason to treat the post-mortem redemption of shares held by such trusts differently from the redemption of shares held by an estate, when capital losses are used to offset gains arising on death.

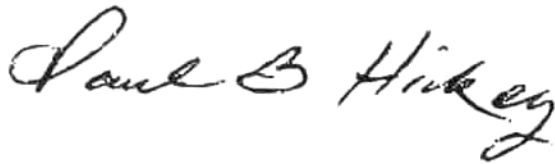
We note that another “stop-loss rule” in the Act provides parallel treatment for estates and for spousal trusts, alter ego trusts and joint spousal trusts. Subparagraph 112(3.2)(a)(iii) provides relief from the reduction of a capital loss on the disposition of a share that would otherwise occur under that subsection for estates if the particular share was acquired as a consequence of the death of an individual and the disposition occurs in the first taxation year of the estate. Subparagraph 112(3.3)(a)(iii) provides similar relief from the reduction of a capital loss on the disposition of a share that would otherwise occur because of the application of that subsection to the extent of a capital gain that arises on the deemed disposition of the share under subsection 104(4). This relief in subparagraph 112(3.3)(a)(iii) applies to trusts that are spousal trusts, alter ego trusts and joint spousal trusts.

Recommendation

We recommend that a rule be introduced to exclude the application of subsection 40(3.6) when shares held by a spousal trust are redeemed following the death of the spouse. A similar rule should be introduced for alter ego trusts and joint spousal trusts.

We trust that you will find our comments and recommendation helpful and, as always, we would be pleased to meet with you at a convenient time to elaborate on this submission.

Yours truly,



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