TAX PLANNING FOR DISPOSITIONS OF DEPRECIABLE PROPERTY AT DEATH*

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Tax planning for the death of a taxpayer must depend on the ultimate cost, determined by such factors as marginal rates of the parties, income averaging annuity contracts, and amount of accelerating tax payable with an inter vivos *transfer. These tax factors must be considered before the appropriate "better" or "cheaper" tax plan can be achieved.*

Tax planning for the death of a taxpayer may in certain circumstances require that consideration be given to an *inter vivos* transfer of depreciable property, as an alternative option to the deemed disposition of capital property on death. The full implications of an *inter vivos* transfer versus a deemed disposition on death will, of course, vary with the nature of the depreciable property owned by the taxpayer, the time when it was acquired, and the contemplated time-interval between an *inter vivos* transfer and death. Hence, the temptation to base decisions on the quantum of the total capital gain or recapture of capital cost allowance (CCA) should be resisted until the analysis is carried forward to the ultimate tax cost involved, predicated on the relative marginal tax rates that would apply and the magnitude of the potential tax acceleration. The purpose of this paper is to illustrate some of these factors to be considered and to highlight the potential tax consequences of disposition, either on death or by *inter vivos* transfer, of depreciable property acquired before and after December 31, 1971.

I. POST-1971 DEPRECIABLE PROPERTY HELD AT DEATH

Where a taxpayer dies holding depreciable property[1] at death, the taxpayer is deemed to have disposed, immediately before his death, of all depreciable property owned by him at that time, for proceeds equal to the value halfway between undepreciated capital cost (UCC) and fair market value (FMV).[2] By virtue of this deeming provision it is possible for the taxpayer to suffer a recapture of capital cost allowance (CCA),[3] or a capital gain,[4] or to be allowed a terminal loss.[5] It should be observed that while the regulations only permit the deduction of a terminal loss "otherwise than on death", the taxpayer is permitted a terminal loss on death by virtue of the deeming provision in s. 70(5), which deems the disposition of the depreciable property to occur "immediately before his death". The taxpayer, however, cannot have a capital loss on the disposition of depreciable property.[6]

The effect of the above-mentioned provisions may be seen in Table A which follows:

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[1] Depreciable property is included in capital property by s. 54(b) and is defined in s. 13(21)(b) as property on which capital cost allowance (CCA) may be claimed under s. 20(1)(a), as prescribed by the Regulations. All statutory references in this paper refer to the Income Tax Act, S.C. 1970-71-72, c. 63.

[2] S. 70(5)(b).

[3] S. 13(1).

[4] S. 39(1).

[5] Reg. 1100(2).

[6] S. 39(1)(b).

Table A

DEEMED DISPOSITION OF DEPRECIABLE PROPERTY ON DEATH
(Deemed Proceeds in Excess of Original Cost)

DATA: Taxpayer died owning one asset—Class 8—with:

Original Cost	= $200,000
UCC at Death	= 120,000
FMV at Death	= 320,000

TAX EFFECT ON DECEASED:

Deceased's Deemed Proceeds	= UCC + ½ (FMV - UCC)
	= 120,000 + ½ ($320,000 - 120,000)
	= $220,000
Recapture of CCA	= $ 80,000
Capital Gain	= $ 20,000

At the same time the beneficiary is deemed to acquire the depreciable property at a cost equal to the deemed proceeds of the deceased (in this case $220,000) or on a *pro rata* basis where the beneficiary acquires less than all the depreciable property of a prescribed class.[7]

Where, however, the capital cost of the deceased exceeds his deemed proceeds, the net effect will be to partially defer recapture of CCA until such time as the beneficiary sells the particular depreciable property.[8] The partial deferral permitted by these provisions may be seen in Table B:

Table B

DEEMED DISPOSITION OF DEPRECIABLE PROPERTY ON DEATH
(Original Cost in Excess of Deemed Proceeds)

DATA: Taxpayer died owning one asset—Class 8—with:

Original Cost	= $200,000
UCC at Death	= $120,000
FMV at Death	= 240,000
FMV on Subsequent Sale by Beneficiary	= $240,000

TAX EFFECT ON DECEASED:

Deceased's Deemed Proceeds	= UCC + ½ (FMC - UCC)
	= 120,000 + ½ (240,000 - 120,000)
	= $180,000
Recapture of CCA	= $ 60,000

TAX EFFECT ON BENEFICIARY:

Beneficiary's Deemed Capital Cost for CCA Purposes	= $200,000
CCA Deemed Allowed to Beneficiary	= 20,000
UCC to Beneficiary	= $180,000
Beneficiary's Proceeds on Sale	= $240,000

7. S. 70(5)(d).
8. S. 70(5)(e).

Excess	= $ 60,000	
Recapture of CCA from Beneficiary	= $200,000 - 180,000 =	$20,000 (1)
Capital Gain to Beneficiary	= $240,000 - 200,000 =	$40,000 (2)
(1) + (2)	$20,000	
	+ $40,000	
	= $60,000	

COMBINED EFFECT ON DECEASED AND BENEFICIARY:

Total Recapture—	
From Deceased	$60,000
From Beneficiary	$20,000
	= $80,000
Total Capital Gain—	
From Deceased	$ 0
From Beneficiary	$ 40,000
	= $ 40,000

Thus, of the potential recapture to the deceased of $80,000, the provisions cause the estate to suffer an actual recapture of $60,000 on the death of the taxpayer and permit a deferral of $20,000 recapture of CCA until the subsequent disposition by the beneficiary. This result may be contrasted with the full recapture which would ensue from a non-arm's-length *inter vivos* sale,[9] unless made to a spouse under s. 73. Further, while on an initial examination of Table B it may appear that the beneficiary's capital gain should amount to $60,000 (being the difference between the FMV proceeds of $240,000 and the beneficiary's deemed cost of $180,000) [under s. 70(5)(d)], such an interpretation would amount to double taxation of the $20,000 overlap. Since the $20,000 difference between $200,000 and $180,000 has already been brought into income through recapture of CCA, and a capital gain is one which would not otherwise be brought into income,[10] it is necessary to exclude the $20,000 overlap and compute the beneficiary's capital gain in the manner indicated in Table B.

Before leaving this area a final caveat should be made with respect to rental properties, which, if acquired after 1971, at a cost in excess of $50,000, are required to be treated as separate classes.[11] Since a beneficiary's capital cost for purposes of CCA may be higher than his deemed acquisition cost,[12] where the beneficiary's deemed cost is less than $50,000 and the deceased's capital cost is in excess of $50,000, the properties may have to be treated as separate classes. Hence, while the separate classes rule is intended to catch post-1971 rental property acquisitions over $50,000, that same rule may operate to affect pre-1972 rental properties by operation of the deeming provisions discussed.

II. DEPRECIABLE PROPERTIES OWNED BY A TAXPAYER ON DECEMBER 31, 1971

Where a taxpayer dies owning depreciable property which he owned without interruption from December 31, 1971, the deemed disposition

[9] S. 69.

[10] S. 39(1).

[11] Reg. 1101(1ac).

[12] S. 70(5)(e) and (d), s. 70(6)(e) and (d).

provisions applicable on the death of the taxpayer are modified by the Income Tax Application Rules (ITAR). These rules, specifically ITAR 20(1)(a) and (b), cover both arm's-length and non-arm's-length dispositions. As the purpose of this paper is to examine the deemed disposition of depreciable property on death, the discussion following emphasizes the non-arm's-length aspects.

The purpose of ITAR 20(1)(a) is to exclude from the capital gain that portion of any increase in the value of depreciable property which may have accrued to V-Day, and to include any accretion in value subsequent to V-Day. The effect of this provision may be seen in Table C:

Table C

DEEMED DISPOSITION ON DEATH

DATA: Taxpayer Died Owning One Asset—Class 8—with:	
Original Cost	= $100,000
UCC at Death	= 90,000
V-Day Value	= 105,000
FMV at Death	= 140,000
(Property transferred to Son)	
FMV on Sale by Son to Arm's-Lengh Purchaser	= 140,000
TAX EFFECT ON DECEASED:	
Deceased's Deemed Proceeds [s. 70(5)(b)(i)]	= UCC + ½ (FMV - UCC)
	= 90,000 + ½ (140,000 - 90,000)
	= $115,000
Deceased's Adjusted Proceeds [ITAR 20(1)(a)]	= OC + [Excess of Deemed Proceeds over V-Day] (if any)
	= $100,000 + [115,000 - 105,000]
	= $110,000
Adjusted Proceeds	= 110,000
Capital Cost	= 100,000
Capital Gain	= $ 10,000
Recapture of CCA	= $ 10,000
TAX EFFECT ON BENEFICIARY (SON) IN ARM'S-LENGTH SALE:	
Proceeds of Disposition	= $140,000
ACB of Property Acquired [s. 70(5)(d)]	= 115,000
Capital Gain	= $ 25,000
TOTAL CAPITAL GAIN:	
Deceased's Capital Gain	= $ 10,000
Beneficiary's (Son's) Capital Gain	= 25,000
Total Capital Gain	= $ 35,000

In Table C above, the total capital gain resulting from the transactions described is $35,000, which is equal to the difference between FMV and

V-Day value ($140,000 - $105,000).[13] Hence, the gain accrued from the date of acquisition (pre-1972) to V-Day ($100,000 - $105,000) is excluded from the capital gain portion which will be subject to inclusion in income. As indicated earlier, the rationale of ITAR 20(1)(a) is to avoid any retroactive application of the capital gains provisions, and this objective is achieved in the illustration described.

The computation in Table C does, however, raise a question as to the beneficiary's deemed acquisition cost on the death of the taxpayer. Where depreciable property owned by a taxpayer on December 31, 1971, is deemed disposed of on the death of the taxpayer by s. 70(5)(b), does the beneficiary acquire that depreciable property at a cost equal to the unadjusted deemed proceeds of s. 70(5)(b) [$115,000 in Table C] or the proceeds received under s. 70(5)(b) as adjusted by ITAR 20(1)(a) [$110,000 in Table C]? Revenue Canada has adopted the view that ITAR 20(1)(a) does not apply to any subsequent owners after May 6, 1974, and that the beneficiary acquires the depreciable property at the equivalent of the unadjusted proceeds.[14] This interpretation is advantageous to the taxpayer (beneficiary), since the adjusted proceeds will be less than the unadjusted deemed proceeds computed under s. 70(5)(b).

It is also worthy of observation at this point, in anticipation of a problem discussed later in this paper, that the total capital gain which would result from the taxpayer having made an *inter vivos* non-arm's-length disposition to his son, and the subsequent disposition by the son to an arm's-length third party, would be identical to the amount computed in Table C above—*i.e.* $35,000. The computation of the total capital gain in this latter *inter vivos* disposition may be seen in Table D below:

Table D

INTER VIVOS TRANSFER

DATA: Same Facts as in Table C, Except that the Disposition from the Taxpayer to the Son is Made *Inter Vivos*

TAX EFFECT ON TRANSFEROR TAXPAYER:

Adjusted Deemed Proceeds [ITAR 20(1)(a)]	= OC + [Excess of FMV Over V-Day] (if any)
	= $100,000 + (140,000 - 105,000)
	= $135,000
Adjusted Proceeds	= $135,000
Capital Cost	= $100,000
Capital Gain	= $ 35,000
Recapture of CCA	= $ 10,000

TAX EFFECT ON TRANSFEREE (SON):

Son's Capital Costs:	(i) for purpose of capital gains computation equals $135,000 [ITAR 20(1)(b)(i)]

[13] In an arm's-length disposition and subsequent sale to a third party, the total capital gain would be identical, *i.e.* $35,000.

[14] I.T. 217, "Capital Property owned on December 31, 1971" para. 8 (May 26, 1975).

	(ii) for purpose of transitional rules equals $100,000 [ITAR 20(1)(b)(ii)]
Adjusted Proceeds [ITAR 20(1)(a) and 20(1)(b)(ii)]	= OC + [Excess of FMV over V-Day] (if any)
	= $100,000 + (140,000 - 105,000)
	= $135,000
Adjusted Proceeds	= $135,000
Capital Cost per ITAR 20(1)(b)(i)	= 135,000
Capital Gain	= NIL
TOTAL CAPITAL GAIN:	
Transferor's Capital Gain	= $ 35,000
Transferee's Capital Gain	= NIL
Total Capital Gain	= $ 35,000

Whilst the total capital gain is $35,000 under either of the alternatives discussed,[15] it is worthy of emphasis that there are differences between the two situations contemplated. These differences may be attributed to three factors. First, the marginal rates of the two taxpayers may be substantially different. Hence, assuming that the transferor's marginal tax rate is substantially higher than the transferee's marginal rate, an *inter vivos* transfer would place a heavier burden on the transferor (capital gain of $35,000) than a deemed disposition on the death of the same taxpayer (capital gain of $10,000). Thus, continuing with the same hypothetical figures used in Tables C and D, and assuming marginal tax rate figures as indicated, the difference in tax attributable solely to the element of a progressive rate structure is shown in Table E:

Table E

RELATIVE TAX CONSEQUENCES

	Marginal Tax Rates (assumed)
DATA: Deceased's or Transferor's	65%
Beneficiary's or Transferee's	25%

TAXABLE CAPITAL GAINS ALLOCATION (TCG):

	Death—Case C		*Inter Vivos*—Case D	
	Capital Gain	TCG	Capital Gain	TCG
Deceased/Transferor	$10,000	$ 5,000	$35,000	$17,500
Beneficiary/Transferee	$25,000	$12,500	NIL	NIL
Total:	$35,000	$17,500	$35,000	$17,500

15 In an arm's-length transfer and subsequent sale to a third party, the total capital gain would be identical, *i.e.* $35,000.

	Death—Case C		*Inter Vivos*—Case D	
	Capital Gain	TCG	Capital Gain	TCG
TAX PAYABLE:				
By Deceased (estate) 65% × $5,000	$ 3,250			
By Beneficiary 25% × $12,500	$ 3,125			
By Transferor 65% × $17,500			$11,375	
By Transferee			NIL	
Total Tax Payable:	$ 6,375		$11,375	

Hence, assuming that the two alternatives occur at the same time (*i.e.* death in Case C and *inter vivos* transfer a day before death in Case D), the difference in total tax liability between the two alternatives would amount to $5,000. Reducing this difference to a generalized concept, it may be said that the differential tax liability in any case will be the difference between the respective marginal rates—here 40%—multiplied by the difference between the taxable capital gains allocated to the higher marginal bracket taxpayer—here $12,500 ($17,500 - $5,000).

Second, there is a difference of timing, the impact of which will depend on the time interval contemplated between transfer and death. An *inter vivos* transfer will have the effect of accelerating the tax on the resulting capital gain in the hands of the transferor taxpayer with the higher marginal rate (assumed in this case). In contrast, the deemed disposition on death will tend to delay, and therefore defer, the tax on the resulting capital gain *vis-à-vis* an *inter vivos* transfer, as well as shift a part of the tax burden to the beneficiary taxpayer with the lower marginal rate (assumed in this case). In the cases discussed above, the difference attributable to the timing of the initial disposition by the deceased/transferor is $8,125, *i.e.* $11,375 less $3,250. The ultimate effect of this timing difference's causing an acceleration in tax will, of course, depend on: (i) the amount involved; (ii) the length of time which elapses between *inter vivos* transfer and death; and (iii) the discount rate applicable during the period between *inter vivos* transfer and death. For the situation discussed above, acceleration of the $8,125 tax liability caused by an *inter vivos* transfer would involve an ultimate cost as indicated in Table F:

Table F

COST OF ACCELERATION

Amount Accelerated	Ultimate Cost @ 8%			Ultimate Cost @ 10%			Ultimate Cost @ 12%		
Years	Years			Years			Years		
	1	3	5	1	3	5	1	3	5
$8,125	$8,775	$10,236	$11,938	$8,938	$10,814	$13,085	$9,100	$11,415	$14,319

Thus far the discussion has centered on the disadvantages of an *inter vivos* transfer of depreciable property *vis-à-vis* a deemed disposition on death, which disadvantages are caused by the higher marginal tax rate of the transferor/deceased (assumed) and an acceleration of the tax payable. A final difference between the two alternatives lies in the availability of Income Averaging Annuity Contracts (IAAC). An *inter vivos* transferor of depreciable property may, upon the realization of a capital gain ($35,000 in Case D), purchase an IAAC and spread his income receipts over a period of time.[16] The deceased's estate, however, would be ineligible to purchase an IAAC because of age requirements in s. 61(4)(b)(ii), notwithstanding its status as an individual.[17] In any event it is dubious whether the eligibility for an IAAC on an *inter vivos* transfer would sufficiently outweigh the previously discussed disadvantages of such a transfer in light of the fact that receipts from an IAAC would be taxed as income when received.[18]

To this juncture we have assumed, notwithstanding the relative advantages and disadvantages of an *inter vivos* transfer versus a deemed disposition on death, that the total capital gain would be the same in either case—$35,000 in Cases C and D. The reader will recall that the purpose of ITAR 20(1)(a) is to prevent retroactivity in the application of the capital gains provisions, and to protect the gain accrued to V-Day for depreciable property held on December 31, 1971. There remain, however, those anomalous situations wherein such a desired result may not be attained. This anomaly may best be depicted by assuming a new set of hypothetical figures and calculating the capital gain in the same manner as previously adopted. This is done in Table G:

Table G

DEEMED DISPOSITION ON DEATH

DATA: Taxpayer Died Owning One Asset—Class 8—with:

Original Cost	=	$ 30,000
UCC at Death	=	10,000
V-Day Value	=	55,000
FMV at Death (Property transferred to Son)	=	70,000
FMV on Sale by Son to Arm's-Length Purchaser	=	70,000

TAX EFFECT ON DECEASED:

Deceased's Deemed Proceeds [s. 70(5)(b)(i)]	=	UCC + ½ (FMV - UCC)
	=	10,000 + ½ (70,000 - 10,000)
	=	$ 40,000
Deceased's Adjusted Proceeds [ITAR 20(1)(a)]	=	OC + [Excess of Deemed Proceeds over V-Day] (if any)
	=	30,000 + [0]
	=	$ 30,000

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[16] S. 61(1).

[17] Revenue Canada adopts this view in Info. Circ. 72-21, "Income Averaging Annuity Contracts" para. 8 (August 29, 1972).

[18] S. 56(1)(d).

Adjusted Proceeds	= $ 30,000
Capital Cost	= 30,000
Capital Gain	= NIL
Recapture of CCA	= $ 20,000

TAX EFFECT ON BENEFICIARY (SON) IN ARM'S-LENGTH SALE:

Proceeds of Disposition	= $ 70,000
ACB of Property Acquired [s. 70(5)(d)]	= $ 40,000
Capital Gain	= $ 30,000

TOTAL CAPITAL GAIN:

Deceased's Capital Gain	= NIL
Beneficiary's (Son's) Capital Gain	= 30,000
Total Capital Gain	= $ 30,000

In contrast to the situation described in Table G, had the deceased taxpayer made an *inter vivos* transfer the result would have been substantially different, as shown in Table H below:

Table H

INTER VIVOS TRANSFER

DATA: Same Facts as in Table G, Except that the Disposition From the Taxpayer to the Son is Made *Inter Vivos*

TAX EFFECT ON TRANSFEROR TAXPAYER:

Adjusted Deemed Proceeds [ITAR 20(1)(a)]	= OC + [Excess of FMV over V-Day] (if any)
	= 30,000 + (70,000 - 55,000)
	= $ 45,000
Adjusted Proceeds	= $ 45,000
Capital Cost	= 30,000
Capital Gain	= $ 15,000
Recapture of CCA	= $ 20,000

TAX EFFECT ON TRANSFEREE (SON):

Son's Capital Costs:	(i) for purpose of capital gains computation equals $45,000 [ITAR 20(1)(b)(i)]
	(ii) for purpose of transitional rules equals $30,000 [ITAR 20(1)(b)(ii)]
Adjusted Proceeds [ITAR 20(1)(a) and 20(1)(b)(ii)]	= OC + [Excess of FMV over V-Day] (if any)
	= 30,000 + (70,000 - 55,000)
	= $ 45,000
Adjusted Proceeds	= $ 45,000
Capital Cost per ITAR 20(1)(b)(i)	= $ 45,000
Capital Gain	= NIL

TOTAL CAPITAL GAIN:

Transferor's Capital Gain	= $ 15,000
Transferee's Capital Gain	= $ NIL
Total Capital Gain	= $ 15,000

Thus it may be seen that in certain anomalous circumstances, such as those described in Tables G and H, a difference may result in the total capital gain depending on whether the depreciable property is deemed to be disposed of at death [Table G] or is the subject matter of an *inter vivos* transfer [Table H]. This anomalous result will usually arise where the subject matter of the disposition is a heavily depreciated asset with a large accrued V-Day value gain, both characteristics likely to exist in the case of assets acquired in the distant past.

Whilst the total capital gain resulting from an *inter vivos* transfer may, in the situation described, be less than the total capital gain from a deemed disposition on death, the choice of one alternative over the other, where such a choice is available, is not an obvious one. Thus, while an *inter vivos* transfer yields the "better" result, it will not necessarily provide the "cheaper" tax option: "better", in that the gain accrued to V-Day is exempt from tax, and the only portion subject to tax is the increase in value from V-Day to the date of transfer—$15,000 ($70,000 - $55,000); whereas in a deemed disposition on death the $30,000 capital gain captures an element of the pre-V-Day accrued gain, and hence is partially retroactive in its application.

The tax consequences of the two options described in Tables G and H, using the earlier assumed marginal rates, may be seen in Table I.

Table I

RELATIVE TAX CONSEQUENCES

DATA:	Marginal Tax Rates (Assumed)
Deceased's or Transferor's	65%
Beneficiary's or Transferee's	25%

TAXABLE CAPITAL GAINS ALLOCATION (TCG):

	Death—Case G		*Inter Vivos*—Case H	
	Capital Gain	TCG	Capital Gain	TCG
Deceased/ Transferor	$ NIL	$ NIL	$15,000	$ 7,500
Beneficiary/ Transferee	30,000	15,000	NIL	NIL
Total:	$30,000	$15,000	$15,000	$ 7,500

TAX PAYABLE:	Death—Case G	*Inter Vivos*—Case H
By Deceased (estate)	NIL	
By Beneficiary 25% × $15,000	$ 3,750	
By Transferor 65% × $7,500		$ 4,875
By Transferee		NIL
Total Tax Payable:	$ 3,750	$ 4,875

Again, notwithstanding the lower total capital gain generated by an *inter vivos* transfer, the taxpayer in our hypothetical illustration would be better advised to permit a deemed disposition on death.

III. CONCLUSION

The extensive computations contained in the text of this paper have highlighted the need for rigorous tax planning in dealing with a taxpayer's post-1971 depreciable property and depreciable property held on December 31, 1971. In the former case, it is important to realize the availability of a deferral with respect to a portion of a potential recapture situation and the possible adverse tax consequences where the depreciable property in question is rental property acquired prior to 1972.

In the latter case two situations have been discussed. In the first situation, the total capital gain resulting from either a deemed disposition on death or an *inter vivos* transfer was identical. It is submitted, however, that this must be the starting point of the analysis and that the ultimate tax cost to the parties may vary considerably, depending on the marginal tax rates of the taxpayers, the cost of accelerating the tax liability in an *inter vivos* transfer and the availability of IAACs. In the second situation, the total capital gain produced by an *inter vivos* transfer was one-half that which would have resulted from a deemed disposition on death. This difference, however, must be interpreted once again in the context of the applicable marginal rates and the cost of accelerating tax liability. In the illustrations depicted, the difference in the applicable marginal rates would make the deemed disposition alternative more attractive in the final analysis. Each case would, of course, require analysis based on the tax factors appropriate to the individual taxpayers concerned. As observed earlier, the "better" result which an *inter vivos* transfer may yield may not necessarily be the "cheaper" tax option for the taxpayers.