Stop-Loss Rules

On December 27, 1997, two years after first tabling the legislation, the government of Canada passed Bill C-69, which included the Stop Loss rules. These rules were further amended by legislation enacted in 2001 to take into account changes in the capital gains inclusion rate.

The New Rules

The rules apply in situations where the issuing corporation redeems the deceased shareholder's shares held by the estate. In these cases, there is a reduction of the capital loss arising from the share redemption that can be carried back to the terminal tax return filed by the deceased.

The example below illustrates how the application of the Stop Loss rules can affect the taxes payable by the deceased taxpayer and estate in cases where the rules for protecting vested rights don't apply or when it is impossible to use other financial plans to reduce the impact.

Sample Calculation:

The example below assumes the following:

- Fair Market Value (FMV) of shares at time of death: $1,000,000
- Adjusted Cost Basis (ACB) of shares: $1
- Paid-up capital (PUC) of shares: $1
- CDA available at time of death: $1,000,000
- Top personal tax rate: 50%
- Top personal tax rate applying to Canadian source dividends: 33%
- Corporation wants to maximize any capital dividend paid

Tax Calculation at Death:

Terminal tax return of deceased shareholder, as originally filed:

A. Deemed disposition of shares:

Deemed proceeds of redemption	$1,000,000
Less: ACB	(1)
Capital gain to deceased shareholder	$ 999,999

This capital gain will be reduced by the capital loss ($999,999 in this example – see next page) carried-back from the estate.

Tax Calculations for the estate:

Redemption of shares by the estate:

B. Redemption of shares:

Proceeds of redemption	$1,000,000
Less: PUC	(1)
Deemed dividend	$ 999,999
Less: Capital dividend	(999,999)
Taxable dividend paid	$ NIL

C. Capital loss to estate, before application of stop loss rules

Proceeds of disposition	$1,000,000
Less: deemed dividend	(999,999)
Adjusted proceeds	$ 1
ACB of shares (to estate)	(1,000,000)
Capital loss to estate	(999,999)

In this situation, the capital loss from the share redemption by the estate would be carried back to the terminal return of the deceased shareholder. Hence, taxes paid in respect of the capital gain by the deceased would be recovered. Note that only $1 of CDA remains.

Application of Stop Loss Rules:

Post-Stop-Loss Terminal Tax Return of the Deceased Shareholder:

With the application of these rules, the $999,000 capital loss to the estate would be reduced by the following amount:

The lesser of:		
The capital dividend received by the estate, and	$999,999	
The capital loss to the estate, minus the taxable dividend, before the stop loss application	$999,999	$999,999
Minus 50%, of the lesser of:		
The capital gain to the deceased per the terminal return, and	$999,999	
The capital loss to the estate, before the stop loss application.	$999,999	(500,000)
Stop Loss Amount		$499,999

With a stop loss amount of $499,999, the loss that is available for carry-back from the estate to the tax return for the final year is reduced. The terminal tax return that was earlier filed would be amended to reflect a revised capital loss carry-back of only $500,000. On the revised capital gains of $500,000, taxes of $125,000 will be due. Note that the CDA balance remains unchanged at $1.

Rules for protecting vested rights

To see whether the former rules (i.e., rules in effect before the stop loss rules came into effect) may be applied to a case involving disposition of shares upon death after April 26, 1995, we must verify whether the shares exist, who holds the title of ownership, what conditions are set out under a written agreement signed before April 27, 1995, or whether the corporation is the beneficiary of a life insurance policy which was in place on April 26, 1995.

Status of shares in place on April 26, 1995

As mentioned, the deceased taxpayer must have owned shares and their disposition must have occurred on the date indicated above. Shares of a successor corporation, which need not be the beneficiary of the insurance contract, can be grandfathered provided the original shares were owned on April 26, 1995.

Written agreement

The protection of vested rights applies when the written agreement made prior to April 27, 1995, provides for the redemption of shares by the corporation. Subsequently, this agreement must not be changed nor modified in any manner whatsoever. Only those who were party to the agreement in place on April 26, 1995 may benefit from the former rules.

A third party to this agreement who subsequently acquired shares would not have such a right, unless appointed for such purpose in the agreement.

In the event that parties to such an agreement wish to modify the terms of their relationship, they must do so in a separate agreement which in no way terminates, invalidates, or replaces the agreement concluded before April 27, 1995.

Insurance policies

The old rules may be applicable to life insurance policies in place prior to April 26, 1995, provided that the corporation is the beneficiary of the insurance policy and it can be demonstrated that one of the main objectives of this life insurance policy was to finance, in whole or in part, the redemption, acquisition or cancellation of the corporation's shares. CCRA expects the policyholder to be able to provide documentary proof of this main objective. In such circumstances, it is not required that the insured be the shareholder; it may be an insurance policy on the life of the shareholder, on the spouse's life or a joint life insurance policy.

Unlike the conditions set out for the written agreement, insurance policy transactions such as renewals, conversions, replacements, or signing of new policies after April 26, 1995, may be carried out without affecting vested rights. The sole requirement for the purposes described above is to present proof of the existence of an insurance policy on April 26, 1995. Because of this, it is strongly recommended that a sample of the insurance policy in force on the date stipulated be conserved for document management purposes.

Conclusion

Stop Loss rules involve a great many unknown factors and there are significant uncertainties as to the interpretation which CCRA reserves for the rules for protecting vested rights. To date, there is no practical cases on which we can determine the limits of this protection. It is important to be cautious and consult professionals to ensure that planning solutions proposed do not imperil vested rights. Keep in mind that from a taxation viewpoint, the application of the former rules is always more favourable for the final after-tax payout.