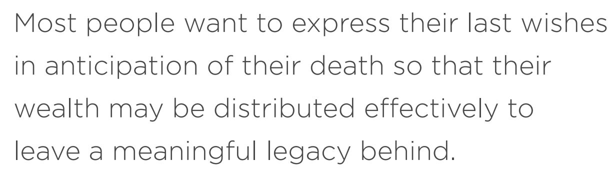
TAX IMPLICATIONS UPON DEATH

iA Financial Group



Most people want to express their last wishes in anticipation of their death so that their wealth may be distributed effectively to leave a meaningful legacy behind.

However, a death has several tax implications that must be well known to implement adequate and effective estate planning.

GENERAL PRINCIPLE

Upon death, taxpayers are subject to general taxation principles. However, several exceptions may apply depending on the circumstances. In practice, some of these exceptions are common.

In Canada, there is no tax payable directly on the inheritance under *the Income Tax Act* ("ITA"). In fact, it is the estate of the deceased, as determined immediately before their death, which is taxed. The tax at death is applied before the deceased's estate is bequeathed to the heirs. Thus, any tax is paid by the deceased and not by their heirs.[1]

However, if at the time of death, the entire estate of a deceased is subject to taxation, their heirs may need to sell assets to generate enough liquidity to pay the tax liability. Therefore, it is important to evaluate the tax at death to implement proper planning and allow the deceased to bequeath their assets to their heirs as they wish.

Note: The masculine is used for the sole purpose of lightening the text.

DEEMED DISPOSITION

Under the ITA[2], a deceased is deemed to have disposed of all his capital properties, as defined in the Act. This disposition is deemed to be made immediately before the death and for proceeds of disposition equal to the fair market value ("**FMV**") of the property at that time. This presumption applies whether there is a real disposition or not. The deemed disposition results in the realization of a capital gain or loss for the deceased taxpayer.[3]

Property subject to the deemed disposition and consequences

In general, all capital properties, depreciable and non-depreciable, are subject to a deemed disposition, namely:

- buildings;
- land;
- shares in private corporations;
- shares in partnerships;
- non-registered investments, such as publicly traded securities, mutual funds, index funds, segregated funds, bonds, debentures, guaranteed notes, etc.;
- depreciable capital assets[4] of all prescribed classes (i.e., rental buildings, machinery, rolling stock, goodwill, etc.);
- Etc.

Registered accounts RRSP, RRIF, LIRA, LIF - Deemed withdrawal

The presumption of deemed disposition also applies to registered investments, such as RRSPs[5], RRIFs[6], LIRAs, LIFs, locked-in RRSPs, pension funds (LIRAs, LIFs), etc. However, the taxation of a registered investment is treated as a withdrawal immediately prior to death. These deemed withdrawals often represent significant income to report on the deceased's final income tax return. They are fully taxed at the deceased's tax rate and may represent a significant tax burden to pay. For example, a taxpayer who holds multiple RRSP investments will be deemed to have withdrawn all these amounts immediately before his death.

In addition, the withdrawal is deemed to be made for an amount equal to the FMV of the investment at the time of death. When the investments are invested in the markets, their FMV may be higher at the time of death than at the time of the liquidation of the estate. Thus, the estate may receive an asset whose value is less than the amount used to establish the tax base for the deceased. Otherwise, when the investments increase in value, the estate would assume the tax payable on the capital gain between the time of death and the time of remittance.

TFSA

Income generated in a TFSA between the beginning of the year and the time of death is not taxable. At the time of death, the FMV of the TFSA is received tax free by the estate of the deceased. These amounts do not have to be reported on the deceased's final tax return. Income generated in the TFSA after a taxpayer's death will be taxable for his estate. In addition, under certain conditions, it may be possible to transfer the amounts invested in the deceased's TFSA, into an heir's TFSA (spouse), without affecting his contribution room.[7]

Income earned in the current year

Income earned and received by the deceased between the beginning of the year and the time of death (such as income from employment, pension, dividends, etc.) is taxed on the deceased's final income tax return.

In addition, income generated by non-registered investments between the beginning of the year and the date of death will have to be reported and taxed on the deceased's final income tax return. After death, the income from these investments is taxed to the estate.

Probate fees (in applicable provinces)

The probate is a judicial process to validate the will and the powers of the executor of a deceased's estate following death. In the absence of a will, the court will appoint an executor responsible for the administration of the estate.

Probate fees are not a death tax under the ITA. In most provinces, probate fees are based on the total value of the estate, subject to certain exemptions. The amount is a fixed amount in certain provinces and in others a percentage of up to 1.7% of the estate's value. In Alberta, as well as in the territories, probate fees are fixed. In Quebec, minimal court fees may apply to wills that are not notarized. As a result, probate fees reduce the estate that can be transferred to the deceased's heirs.

By designating beneficiaries on a life insurance policy and/or segregated fund contract, the death benefit can be excluded from the estate and distributed directly to the beneficiaries. Thus, the sums paid to beneficiaries in accordance with this designation are paid without flowing through the estate and are not subject to probate fees. Donations made during one's lifetime or transfers to a trust can also reduce the estate's assets to which probate fees apply, under certain conditions.

COMMON EXCEPTIONS

Spousal rollover

The ITA provides for a tax-free rollover in favour of the spouse at the time of death[8]. This exception applies to all types of assets that make up the deceased's patrimony that are devolved irrevocably to the spouse. Thus, this rollover allows the tax payable resulting from the deemed disposition of the deceased's properties to be deferred until the death of the surviving spouse. Since spousal rollover is automatic, the ITA does not require an election to be made/filed. However, the legal representatives of the deceased may opt out of the automatic rollover[9].

Principal residence

The disposition of the principal residence (when the conditions of the ITA are met) is not taxable[10]. This rule is also true in the event of death. However, this exception applies only to one residence at a time. Thus, if a person owns more than one residence at the time of death, their legal representatives would choose which residence to apply the exemption to.[11] Upon death, the remaining residences will be deemed to have been disposed of at their FMV and, if applicable, the accrued taxable capital gains would be included on the deceased's final income tax return.

Life insurance

Under the ITA, the proceeds of a life insurance policy in Canada paid to a beneficiary who is a Canadian resident are tax free. This general rule applies to any type of policy, with few exceptions. As a result, designated beneficiaries, including estates, do not have to pay tax on amounts paid as death benefits. For universal life insurance and participating whole life insurance, the death benefit includes the capitalization fund.

In a corporate context, taking out life insurance may provide the corporation, or the surviving shareholders, if applicable, with the necessary liquidity to redeem the shares devolved to the estate. Thus, the heirs will be able to pay the taxes and keep the balance.

In addition, the death benefit paid to a corporation increases its capital dividend account ("CDA") and may eventually allow the corporation to declare and pay shareholders a tax-free capital dividend. For more details on the calculation of the CDA, please refer to our document on this subject[12].

Capital gain deduction

Shares that qualify as small business corporation shares ("**QSBC**")[13] may be eligible for a capital gain deduction[14] on disposition up to a prescribed amount. In addition, to qualify as QSBC, shares must meet several conditions set out in the ITA. In the event of death, the shares may not qualify as QSBC shares if one of the conditions is not met, namely the one relating to the ratio of assets used in an active business in Canada at the time of death.

The capital gain deduction also applies to the disposition of qualified farm or fishing property and to shares of the capital stock of a family farming or fishing corporation[15].

Rollover in favour of a child or parent in agriculture and fishing

In the event of death, the ITA allows the transfer of farm or fishing property[16], shares of a corporation and interests of a family farming or fishing partnership[17] without any tax impact on the deceased's child. The transfer of a farm or fishing property can be made at the adjusted cost base ("**ACB**") without incurring any tax implications for the deceased. The ITA also allows for the transfer of these types of property from the deceased child to his parents if the child had received this type of property from the parent by way of tax rollover (on death or during their lifetime)[18] under the ITA.

Losses

Losses realized on the deemed disposition at death, or losses that have been carried forward, such as capital losses, may be deducted by the estate against realized gains. Tax planning can be implemented to take advantage of losses carried forward. For example, the legal representatives of the deceased may choose not to transfer certain assets on a tax-free rollover basis to the spouse but rather choose to generate a capital gain for the purpose of deducting a loss. As mentioned, since the spousal rollover is automatic, the legal representatives of the deceased may elect an asset out of this rollover to generate a gain and take advantage of the loss incurred in years prior to the death, if applicable.[19]

Loss carryback from the estate to the deceased's final return

The ITA sets out loss carryback rules allowing the legal representatives of a deceased to elect[20], within one year of death, to reduce the deceased's tax liability determined on the deceased's final income tax return. Loss carryback rules may be limited by stop-loss rules[21] in cases where a capital dividend from a life insurance product is ultimately declared and paid to the deceased's estate.

The rules for carrying forward capital losses and minimizing losses will be detailed and discussed at length in another document on the Advanced Case Solutions website.

Charitable donations

Charitable donations are eligible for a non-refundable tax credit up to a certain threshold calculated on taxable income, which normally corresponds to 75% of annual net income. In the year of death, the tax credit is increased up to 100% of net income.

Also, the deceased may, prior to his death, donate capital assets, such as publicly traded shares, to a charity and thus avoid the accrued taxable capital gain on these shares.

The estate can also donate directly and claim the tax credit in the year of death or carry it back to a year before the death. In this case, the estate will be entitled to the non-refundable credit.

Testamentary trust

A testamentary trust is created by a will. Contrary to the spousal trust, the transfer of the deceased's estate to the testamentary trust has tax implications: deemed disposition of property and taxation for the deceased. The testamentary trust is settled to entrust the administration of the deceased's properties to one or more of the trustees, in favour of the beneficiaries, while respecting the wishes of the deceased (settlor). For example, a testamentary trust may be established when the beneficiaries are unable to administer the assets of the estate, notably when the beneficiaries are minors or lack the legal capacity. A testamentary trust can also be useful when the settlor does not have complete confidence in their heirs' abilities or when the latter are facing significant financial problems. In this case, it is possible to protect the assets and income bequeathed by the deceased from the heirs' creditors.

Henson trust

The ITA allows the transfer of a deceased's RRSP[22] to a Henson trust[23] intended for the deceased's mentally disabled spouse or dependent child. The beneficiary of the trust will be taxed on the amounts received from the Henson trust. Upon their death, the beneficiary of a Henson trust will be taxed on the remaining balance of the trust's assets. The ITA does not impose any age limit for the Henson trust.

Rollover through a testamentary trust for the benefit of the spouse

Spousal rollover can also be done through a testamentary trust for the exclusive benefit of the surviving spouse[24]. Thus, the property of the deceased (the settlor) and the income generated after the death can be transferred to the spouse, while retaining some control over their potential devolution. The transfer of the assets is tax free at the time of death. In general, the trustees appointed by the settlor are responsible for maintaining the lifestyle of the surviving spouse throughout their life. To this end, they are instructed to use the income of the trust and, if necessary, they can encroach on the capital. In addition, the settlor can ensure that the balance of the trust's patrimony will be distributed to the persons of their choice, after the death of the surviving spouse. This strategy is particularly interesting for those who want to ensure that their spouse does not squander their wealth. In addition, the surviving spouse would not be able to bequeath the assets of the trust to persons other than the beneficiaries designated by the settlor. For example, this type of trust may be implemented to prevent the deceased's property from eventually being bequeathed to a new spouse.

Transfer of an RRSP (or RRIF) to a minor child

The general rule mentioned above indicates that if the deceased held registered accounts (RRSP or RRIF) at death, the amounts may be added to the deceased's final income tax return. However, the deceased's RRSP[25] (or RRIF)[26] can be used to acquire an eligible annuity for a dependent minor child, tax free. This fixed term annuity ends when the child turns eighteen. The child will be taxed annually on the amount of the annuity. Thus, it is possible to spread the taxation of the deceased's RRSP (or RRIF) over time.

Deceased's final tax return

The deceased's final income tax return includes all income generated on the deemed disposition and withdrawals from registered plans upon death. In addition, all income earned by the deceased from the beginning of the year until the time of death is also included on the final return. Total taxable income is taxed at the usual graduated rates.

Filing deadline:

If the individual's death occurs between January 1 and October 31, the final income tax return must be filed by April 30 of the following year. If the death occurred between November 1 and December 31, the final tax return must be filed six months after the date of death.

In addition, in general, if the deceased or his spouse was operating a business, the filing dates would be June 15 of the following year if the death occurred between January 1 and December 15 of the year and six months after the death if the death occurred between December 16 and 31 of the year.

Income tax returns for rights or things

The ITA allows the filing of a separate income tax return for income from rights or things[27]. The following incomes are included on this income tax return and are taxed at the usual graduated rates:

- amounts that have not yet been received at the time of death and that, but for death, would have been included in the deceased's income following their receipt;
- employment-related income that was not received prior to the death, such as salary, commissions, and vacation pay;
- dividends declared but unpaid, Old Age Security pensions due and payable before death, bond interest coupons, due and uncashed, and interest on bonds accrued before the last interest payment date prior to the death that have not been paid and reported in previous years[28].

Filing deadline:

If applicable, the income tax return for rights or things must be filed no later than 90 days after receipt of the notice of assessment of the deceased's final income tax return or one year after the date of death, whichever is later.

Estate income tax return

When a person dies, his patrimony at that time forms their estate. The estate may continue to receive income until the estate's net assets are distributed to the legatees. If applicable, a separate income tax return must be filed and the tax payable must be paid until the estate has fully distributed its assets to the heirs.

Filing deadline:

The filing due date is 90 days following the estate taxation year-end. For the first year, the legal representative of the estate can choose the estate taxation year-end within 12 months of the death[29].

36 months after the death, the taxation year-end is deemed to be December 31[30]. Thus, in cases where the estate has not yet been liquidated, the estate must file an income tax return 90 days after the taxation year-end, either March 31 or March 30 (leap year).

Taxation of the estate (Graduated Rate Estate ("GRE"))

After death, the deceased's assets become part of their estate, which is a GRE for tax purposes. Thus, before its dissolution, the estate shall report incomes generated by said assets since the date of death and pay the related tax liability.

The ITA allows for the filing of a tax return for income from the GRE[31]. Where the deceased was a beneficiary of a GRE, their legal representatives may elect to include, on an income tax return filed to this effect, incomes received from said GRE after the end of said GRE's financial year and ending on the deceased's date of death.

GREs offer a great benefit, namely graduated tax rates for 36 months. After this period, the estate will be taxed at the highest marginal rate. To qualify, the estate must meet certain criteria, such as being designated as a GRE on its first tax return. No other estate of the individual shall be designated as GRE; all assets must have devolved by cause of death, and the estate shall use the deceased's social insurance number on its income tax return.[32]

Important points

Payment of the deceased's tax liability may require significant liquidity. To avoid selling assets and/or financing them to pay this tax liability, the proceeds of a life insurance policy would allow the estate to have access to funds quickly. In addition, life insurance as a financial tool may help reduce the tax liability at death, since it does not generate capital gains unlike a non-registered product.

The tax impacts in the event of death are extensive. Therefore, it is important to discuss these impacts with your clients, to establish a plan to reduce their tax liability upon death, and to ensure that their heirs receive an amount that corresponds to your clients' last wishes.

Finally, clients should always work with their various professionals to establish the appropriate financial and tax planning strategies and have all the necessary legal documents, such as a will, drawn up and reviewed on a regular basis.

1 Most Canadian provinces et territories (except Quebec) impose probate fees on the deceased's estate for a court of law to validate the authenticity of the will. Probate fees vary for each province and territory and are not the subject of this text. We will therefore focus on the income tax applicable at the time of death.
2 Paragraph 70(5)(a) ITA.
3 Paragraph 39(1)(a) ITA.
4 Where a depreciable capital property has been subject to capital cost allowance ("CCA"), the deemed disposition on death may result in a recapture of CCA or a terminal loss.
5 Subsection 146(8) ITA.
6 Subsection 146.3 (6) ITA.
7 Subsection 207.01 (1) ITA.
8 Paragraph 70(6)(a) ITA.
9 Subsections 70(6) and (6.2) ITA.
10 Paragraph 40(2)(b) ITA for a principal residence defined under section 54 ITA.
11 The principal residence designation may require analysis to maximize the exemption.
12 Capital dividend account (ia.ca)
13 Subsection 110.6(1) ITA under the definition: "qualified small business shares".
14 Subsection 110.6(2.1) ITA.
15 Subsection 110.6(1) ITA, definition: "qualified farm or fishing property" and "share of the capital stock of a family farming or fishing corporation". The capital deduction is currently $1,000,000 (clause 110.6(2.2) ITA).
16 Subsections 70(9) and 70(9.01) ITA.
17 Subsections 70(9.2) and 70(9.21) ITA.
18 Subsection 70(9.6) ITA. By way of rotation on death under subsections 70(9.01), 70 (9.11), 70 (9.21), 70 (9.31) ITA and on living under subsections 73(3.1) and 73(4.1) ITA.
19 Subsections 70(6) and (6.2) ITA
20 Subsection 164(6) ITA
21 Subsection 112(3.2) ITA
22 Subsection 60.011(3) ITA.
23 Subsection 60.011 (1) ITA: the Henson trust.
24 Paragraph 70(6)(b) ITA.
25 Subsections 146(1) and 60(l) ITA.
26 Subsections 146.3(1) and 60(l) ITA.
27 The income tax return for rights or things may be filed pursuant to subsection 70(2) of the ITA.
28 For more details see: Income tax return from rights or property- Canada.ca
29 Paragraph 249(1)(c) ITA
30 Subparagraph 249(4.1)(a)(ii) ITA
31 Paragraph 104(23)(d) ITA
32 Subsection 248(1) ITA "Graduated Rate Estate".

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