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TAX LETTER

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DEATH AND TAXES

You've heard the saying about this – there are two sure things in life.

On top of that, when you die, there may be additional income tax payable owing to the "deemed disposition" rules and other rules that apply specifically upon death.

Before we get to those issues, in the year of death, all income you earn or receive before death is normally included in income in that year and must be reported on the tax return for that year (often called the "terminal return"). The person administering your estate, such as your executor or other legal representative, is required to ensure that the terminal return is filed.

The normal tax-filing date for a taxation year for an individual is April 30 of the following year, or June 15 of the following year if you or your spouse (or common-law partner) carry on business in the taxation year.

For the terminal return, the tax-filing date may be extended, as it is the later of the normal tax-filing date and six months after the date of death. A similar six-month extension may apply for any balance of tax owing.

> Example
>
> Jane died on December 1, 2020. Neither she nor her spouse carried on business. The tax-filing date and the tax balance-due date for the 2020 year is extended to six months after December 1, 2020, or June 1, 2021, instead of the normal April 30 deadline.

A similar six-month extension can apply if the person dies in one year before the tax-filing date for the previous year. However, this administrative extension by the CRA applies only to the *filing* deadline, not the balance-due deadline.

> Example
>
> Nina died on March 1, 2021. Neither she nor her spouse carried on business. Nina had not filed her 2020 tax return before her death.
>
> The tax-filing date for the 2020 year is extended to six months after March 1, 2021, or September 1, 2021, instead of the normal April 30 deadline. However, any balance owning was still due by April 30, 2021, and interest will apply to any balance unpaid as of that date.
>
> The tax-filing deadline and balance-due date for the 2021 terminal year will be April 30, 2022, since that is later than six months after Nina's death.

Deemed disposition rules

As mentioned, there are deemed disposition rules that apply upon your death.

Under these rules, you are deemed to have disposed of most of your capital properties at death for fair market value proceeds. The person who inherits the property from you is deemed to acquire it at a tax cost equal to the same fair market value. (There is an exception where the property passes to your spouse or common-law partner, as discussed below.)

As a result, accrued capital gains and losses on these properties will be triggered upon your death and must be reported on your terminal return. Like capital gains and losses during your lifetime, only one-half of the gains are included in income.

The reason for the deemed disposition? Capital gains are only taxable when there is a disposition of the property. So someone might own property for many years with significant accrued gains that have not been taxed. Without the deemed disposition at death, the accrued gains could go untaxed indefinitely, which is obviously something the government wanted to avoid when they introduced the deemed disposition rules.

Special rules for capital losses

Under regular rules, one-half of capital losses are allowable capital losses, which can be used only to offset taxable capital gains and not other sources of income.

These rules are relaxed when a person dies. In this case, if the allowable capital losses in the terminal year, including those resulting from the deemed disposition rules, exceed the taxable capital gains for the terminal year, the difference is called the "net capital loss" for the year.

The net capital losses can be applied against other sources of income, either in the terminal year or the preceding year. If the return for the preceding year was already filed, the executor or legal representative can file a Form T1-ADJ, "T1 Adjustment Request", to request a carry-back of the loss to that year.

The only catch is that this special treatment of the net capital loss is reduced to the extent that the deceased claimed the capital gains exemption (the exemption for taxable capital gains from dispositions of qualified small business corporation shares or qualified farm or fishing property).

> Example
>
> John died in 2021. He had net capital losses in 2021 of $20,000. John had claimed a $12,000 capital gains exemption in earlier years. The difference of $8,000 can reduce John's other sources of income (e.g. employment, business or property income) in either 2021 or 2020.
>
> Alternatively, the $20,000 net capital losses could be carried back for up to three years to offset taxable capital gains under the regular rules. For example, if John had $30,000 of taxable capital gains in 2019, the net capital loss could be carried back to 2019 to reduce those taxable gains to $10,000.
>
> (There can be various different options and scenarios, and the most beneficial option would depend on the facts.)

A similar rule applies if the deceased has net capital losses from previous years that have not yet been utilized.

> Example
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> Ahmed died in 2021. He had $20,000 of net capital losses from 2018 that had not been used.
>
> In 2021, he had $6,000 of taxable capital gains. He previously claimed a $5,000 capital gains exemption.
>
> In 2021, the net capital losses from 2018 can reduce the taxable capital gains to zero, leaving $14,000 of net capital losses.

Net of the $5,000 previously-claimed capital gains exemption, this leaves $9,000 that can be deducted against other sources of income in either 2021 or 2020.

Rollover if property left to spouse

If the deceased's property is left to their spouse or common-law partner, a tax-free "rollover" is allowed. Under this rule, the deceased has a deemed disposition for proceeds equal to their tax cost and the spouse acquires the property with the same tax cost.

A similar rule applies if the property is left to a qualifying spousal trust. In very general terms, this is a trust from which the deceased's spouse has the right to receive all the income during their lifetime and no one else can obtain the capital of the trust during their lifetime. Other conditions apply.

However, the deceased's executor or legal representative can elect out of the rollover, in which case the deemed disposition rules discussed above apply. In other words, under the election the property would be deemed to be disposed at fair market value rather than the deceased's tax cost. The election can be made on a property-by-property basis, so one could elect out of the rollover for some property but retain the rollover for other property.

So why would someone make this election out of the rollover?

There are at least three situations where making the election makes sense.

First, there may be property that had an accrued capital loss. If the election is made, the loss will be triggered in the deceased's terminal return, and the capital loss rules discussed above can be used to reduce the deceased's tax.

Second, if the property has an accrued capital gain, but the deceased has allowable capital losses in the terminal year or net capital losses from previous years that can offset that gain, the election will trigger that gain which can be offset by the losses. So the deceased will pay no tax on that gain, as with the rollover situation. However, the spouse will acquire the property with an increased tax cost, equal to the fair market value of the property, rather than the deceased's tax cost. This increased tax cost will decrease the spouse's gain if they later sell the property (or will increase any later capital loss).

Third, gains from the property may be eligible for the capital gains exemption for "qualified small business corporation shares" or "qualified farming or fishing property". The lifetime exemption for small business shares is $892,218 of capital gains, and for farm/fishing property is $1 million of capital gains (2021 figures). If the property has an accrued gain and the deceased has an exemption remaining, the election will trigger the gain, which can be offset by the exemption. So the deceased will pay no tax on the gain, and the spouse gets an increased tax cost.

Furthermore, since the election out of the rollover is done on a property-by-property basis, there is some flexibility depending on the deceased's tax situation.

Example

Pam died in 2021. At the time of her death, she had $200,000 of available unused exemption for capital gains. She owned 100 qualified small business corporation shares. At the time of her death, the accrued capital gain on these shares totalled $400,000. In other words, the fair market value of the shares exceeded her cost of the shares by $400,000. Under her will, she left all of the shares to her spouse.

The election can be made on 50, or half, of the shares. That will trigger a capital gain of $200,000 (half of the total $400,000 accrued gain), which will be offset by the capital gains exemption, leaving no tax payable for Pam. The remaining 50 shares can go under the rollover, again leaving no tax payable for Pam.

Pam's spouse will have a tax cost on the first 50 shares equal to their fair market value. The spouse will then inherit a tax cost on the other 50 shares equal to Pam's tax cost of those shares.

However, under the cost averaging rules in the Income Tax Act, the tax costs of all 100 shares will be averaged out. For instance, if the fair market value of 50 shares was $250,000 and Pam's tax cost of 50 shares was $50,000, her spouse would have a total tax cost of $300,000 for the 100 shares, or $3,000 per share.

Rights and things

Another rule in the Income Tax Act requires a deceased to include in income in the terminal year the value of "rights or things" at the time of death. Although the term is not defined in detail, you can think of rights or things as being income to which the deceased was ultimately entitled but was not included in the regular income tax calculation before death.

For example, under the regular rules, employment income is included in income when it is received. Suppose the deceased taxpayer was an employee who was paid monthly, and died on April 2, 2021 without having received her March 2021 salary. Under the regular rules, the March salary would not be included before the death since it was not received by then. But the March salary will be a "right or thing", and is therefore included in the deceased's income in 2021, subject to the comments below.

Other examples of rights or things include the following:

- Old age security benefits, and Canada Pension Plan or Quebec Pension Plan payments that were payable in the month before the death but not paid until after the death;
- uncashed matured bond or other debt coupons at the time of death;
- interest income receivable before death, but not received and not reported in previous years;
- unpaid dividends declared before the date of death (dividends are typically declared before they are paid); and
- supplies on hand, inventory, and accounts receivable if the deceased was a farmer or fisher and used the cash method of computing income.

There are two ways of reporting rights and things.

First, if an election is made by the later of 1 year after the date of death and 90 days after the date of the notice of assessment for the terminal year, the rights or things are included in a separate tax return. The separate return will include only the value of the rights and things, and not the other income for the deceased which is in the regular terminal return. One cannot split the rights or things between the two returns. The second option is that they all go in the regular terminal return.

The election for the separate return may be beneficial for a couple of reasons.

First, in the separate return, the deceased is treated as a separate taxpayer, and will be taxed at the graduated tax rates that apply under the regular return. Basically, this allows some income splitting between the rights and things and the deceased's other income.

Example

Bela died in 2021 with rights and things valued at $40,000. She also had $300,000 of other taxable income in 2021.

The other taxable income above $216,511 (where the top tax bracket begins) will be subject to the highest marginal federal tax rate of 33% (plus whatever provincial rate applies). Without the election, the $40,000 of rights and things would also be taxed at the 33% federal rate. With the election, the $40,000 will be placed in the separate return and taxed at the lowest 15% federal rate (plus applicable provincial tax).

Second, the deceased can double up on certain tax credits, and therefore claim them in both the regular return and the separate return. The credits that can be claimed on both returns include:

- the basic personal credit;
- the age credit if over 65 years old;
- the spouse or common-law partner credit;
- the eligible dependant credit, sometimes called the equivalent-to-spouse credit;
- the Canada caregiver credit in respect of the deceased's spouse or common-law partner or eligible dependant aged 18 or over; and
- the Canada caregiver credit for certain other infirm dependants.

Tax can be paid over ten years

The income tax resulting from the deemed disposition rules and the "rights and things" rule can be spread out and paid in ten equal instalments, if security is posted with the CRA and the executor or legal representative makes an election. Interest must be paid at the prescribed rate of interest at the time of the election.

Amounts accrued to death

There is also a rule that requires the deceased to include in income certain amounts that accrued to the date of death that would not otherwise be included at that time under the regular rules. This rule includes things like employment income accrued to the date of death – for example, where the deceased died in-between pay cheques. It could also include interest on a bond that accrued to the date of death.

These amounts are **not** eligible for the separate return treatment discussed above.

TAXATION OF AN ESTATE

At the risk of sounding ominous, but continuing on with the deceased theme, this section discusses the tax rules for an estate. Basically, when a person dies, their estate comes into existence at that time as a matter of law. In Quebec, the official term is a succession. To keep things simple, both will be referred to as an "estate" in this discussion, which is also the term used in the federal Income Tax Act.

An estate is considered a trust, a person, and a taxpayer under the Act. As such, if it earns income and owes tax, a tax return must be filed and the tax must be paid, as with any other taxpayer.

An estate is considered a testamentary trust. In most cases, an estate is considered a graduated rate estate ("GRE") for the first 36 months of its existence as long as it remains a testamentary trust (more on this below). After 36 months, it is no longer a GRE and is treated like any other estate or trust.

There are advantages to GRE status.

The main advantage is the application of graduated tax rates to the GRE taxable income, being the same graduated tax rates that apply to individuals during their lifetimes. All other estates or trusts are subject to a flat tax rate at the highest marginal rate, which is 33% federally, and varies from about 49% to 54% when provincial taxes are added, depending on the province in which the estate or trust is resident.

Other advantages of GRE status include:

- The GRE can choose an off-calendar taxation year or a calendar taxation year (all other estates and trusts must use the calendar year);
- The GRE's first $40,000 of adjusted taxable income is not subject to the "alternative minimum tax", which can apply if it has significant tax breaks or amounts that are subject to preferential tax rules; and
- The GRE is not required to pay annual tax instalments.

After 36 months the GRE ceases to be a GRE and is simply an estate that does not qualify for the graduated tax rates and the other tax advantages. However, the GRE can cease to qualify **before** the 36 months in certain other cases. For example, if the estate ceases to be a "testamentary trust" because someone other than the deceased contributes property to the estate (with some limited exceptions), then it ceases to be a GRE and from that point on will not qualify for the tax advantages.

On a final point, the CRA takes the position that a deceased can have only one GRE, even if the deceased has multiple wills and property in different jurisdictions.

ELECTION FOR CAPITAL GAINS TREATMENT FOR CANADIAN SECURITIES

If you sell a security, such as a share, bond, or mutual fund, and realize a gain, the gain will be a capital gain unless you are found to be in the business of selling the security. If you are in the business, the gain will be considered business income.

The difference is significant. A capital gain is only one-half included in income as a taxable capital gain, whereas business income is fully included. On the flip side, a capital loss is only one-half deductible and only against taxable capital gains, whereas a business loss is fully deductible against all sources of income.

If you would like to ensure capital gains treatment for gains on sale of Canadian securities, you can make an election in your tax return for a year. If you do so, your gains from the sale of Canadian securities for that year and all subsequent years will be capital gains. The downside is that all of your losses will be capital losses, which are not as beneficial from a tax perspective compared to business losses.

For these purposes, a "Canadian security" includes a share in a corporation resident in Canada, a unit in a Canadian mutual fund, and bonds and other debt instruments issued by person residents in Canada. Obviously, it does not include foreign securities.

The election is not available for the following persons:

(a) a trader or dealer in securities,

(b) a financial institution such as a bank or trust company,

(c) a company whose principal business is the lending of money or the purchasing of debt obligations or a combination thereof, or

(d) a non-resident person.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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