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# TAX LETTER

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## TAXATION ON DEATH

We all know the old saying that there are only two sure things in life: death and taxes. While that may be true, it is also the case that one must typically pay taxes even after death (in which case the taxes will be paid out of your estate).

The Income Tax Act contains several rules that apply specifically upon the death of an individual. Some of the main rules are as follows.

### Deemed dispositions

Each capital property you own is deemed to be disposed of immediately before your death for fair market value proceeds, and the person acquiring the property (e.g. your heir under your will) is deemed to have a cost equal to that fair market value (FMV). As a result, most of your accrued capital gains and losses will be realized on your death.

Whether the deemed disposition results in a significant tax liability obviously depends on the amount of your accrued gains relative to losses at the time of death.

> Example
>
> At the time of your death, you owned stocks with a cost of $200,000 and FMV of $700,000. You also owned mutual funds with a cost of $500,000 and FMV of $400,000.
>
> The deemed disposition rules will generate a capital gain of $500,000 for the stocks, of which $250,000 will be included in your income (as a "taxable capital gain") since capital gains are only half-taxed. The deemed disposition of the mutual funds will lead to a capital loss of $100,000, of which $50,000 will be an allowable capital loss. You will have income of $250,000 – $50,000, or $200,000, and will be required to pay tax on that amount (on your return for the year of death).

The person inheriting the stocks will have a cost of $700,000 and the person acquiring the mutual funds will have a cost of $400,000.

Whether the deemed disposition results in tax also depends on whether you leave the property to your spouse or common-law partner (or a qualified trust with the spouse or common-law partner as beneficiary). If you do, a tax-free “rollover” normally applies, under which the deemed disposition takes place at your cost, rather than FMV. In other words, there will be no gain or loss on your death.

Example

Assume the facts as above except that the properties are left to your spouse. You will have a deemed disposition at the properties’ cost and your spouse will pick up the same cost. Thus, there is no gain or loss for you, and your spouse’s cost of the stocks will be $200,000 and their cost of the mutual funds will be $500,000.

However, your executor or legal representative can elect out of the rollover to your spouse, in which case the properties are deemed to be disposed of at FMV under the first rule above. For the stocks in the above example, it might make sense to trigger the capital gain if you have unused losses that could offset the capital gain, since this would bump up the cost of the property for your spouse. Also, if the stocks were in “qualified small business corporations” or “family farm or fishing corporations”, the resulting gain could be eligible for the lifetime capital gains exemption, assuming you have some of that exemption remaining. If so, you would pay little or no tax, and again your spouse would have a bumped-up cost of the stocks.

For the mutual funds in the above example, it might make sense for your executor to elect out of the rollover because the FMV deemed disposition would result in a capital loss, which you might be able to use in your final tax return as discussed below.

If you are liable for tax as a result of the deemed disposition rules, your executor can elect to pay the tax in instalments, with interest, over a period of up to 10 years.

## Using capital losses

One-half of capital losses are allowable capital losses, and they can normally only reduce taxable capital gains and not other forms of income.

However, when you die, this rule is relaxed and replaced by a special rule. If you have allowable capital losses remaining after using them against your taxable capital gains, the special rule says that remaining allowable capital losses can be used to reduce your other sources of income such as employment income, and business and property income. (However, the reduction of other sources of income under the special rule may be limited if you have ever claimed the capital gains exemption.)

Where the special rules apply, you can reduce the other sources of income for the year of your death or in the immediately preceding year. If you had already filed the preceding year’s return, your executor can file a form to amend it.

## Accrued wages and similar amounts

If certain amounts of income have accrued to time of your death, and you did not receive them prior to your death, they will be included in your income for the year of death. This will include items such as accrued interest, wages, and other amounts payable periodically that you did not receive before your death.

Example

You are employed and receive a monthly wage of $10,000, payable at the end of the month. You die half-way through a month. The $5,000 wages accrued to the time of your death will be included in your income in the year of death.

## “Rights and things” at death

If you have “rights or things” at the time of death, their value will be included in your income. In general terms, these are rights to amounts that you had at the time of death, which were not otherwise

included in your income because the rights were not realized or disposed of. A common example is unpaid wages from a previous pay period. Another example is a declared dividend on shares you own, which were declared before your death but not paid until after your death.

> Example
>
> You are paid a monthly $10,000 salary at the end of each month. You die in March but have not yet received the salary for February. The $10,000 February salary will be a right or thing, included in your income in the year of death. (Any salary accrued in March to the date of your death will be caught under the above rule under "Accrued wages and similar amounts".)

As with the deemed disposition rules, any tax resulting from the rights and things rule can be paid in up to 10 annual instalments, with interest.

*Alternative treatment for rights and things*

Although the regular rule includes the value of the rights and things in your income, there are two alternative rules that may apply.

First, your executor can elect to report these amounts on a separate tax return (although still under your name). The **separate tax return** will be beneficial because the rights or things will have separate graduated tax rates on those items, rather than being "stacked" on top of your other income in the regular return for the year of death. Also, some personal credits such as the basic personal credit, the spousal credit, the equivalent-to-spouse credit, and the age credit, can be claimed on both the regular and separate return. The election must be made by the later of 1 year after your death and 90 days after the CRA sends the notice of assessment with respect to the year of your death.

> Example
>
> You have $300,000 of regular income in the year of death. You also have $40,000 of "rights or things".
>
> If all the income, including the rights or things, is reported in one return, the rights or things will be subject to the highest marginal tax rate (around 50%, depending on the province). Your personal credits can only be claimed on this return.
>
> If the rights or things are reported on a separate return, they will be subject to the lowest marginal tax rate (about 20-25%, depending on the province). In addition, some of your personal tax credits, like the ones listed above, can be claimed on both the separate return and the regular return, thus eliminating the tax on at least $13,000 of the income.

Alternatively, if the rights or things are transferred to one of your beneficiaries before the election filing deadline, they are not included in your income at all. Instead, they are included in the beneficiary's income once they are realized.

## RRSPs and RRIFs

If you have a registered plan that is a registered retirement savings account (RRSP) or registered retirement income fund (RRIF) at the time of your death, the FMV of the plan at the time of your death is included in your income.

However, if the plan is left to your spouse or common-law partner, it is not included in your income. Instead, it is included in their income. However, they will get an offsetting deduction – meaning no net inclusion and no tax – if they contribute the funds to their own RRSP or RRIF, or to acquire an annuity with certain conditions.

A similar rule applies if you leave the plan to your financially dependent child. If the child is dependent because of a physical or mental infirmity, they can get the offsetting deduction if they contribute the funds to an RRSP, RRIF or to acquire an annuity. If the dependent child is not infirm, an offsetting deduction is allowed only if the child is under 18 years of age, and then only if the funds are used to acquire an annuity payable to age 18.

# SIGNIFICANCE OF CANADIAN RESIDENCY

Your income tax liability in Canada depends on your country of residence for income tax purposes.

If you are resident in Canada, you are subject to tax on your worldwide income, although as discussed below, you may receive a credit for foreign tax paid on that income.

If you are not resident in Canada, you are subject to tax in Canada only on certain Canadian-sourced income.

## Resident in Canada

You must report your income from all worldwide sources on your Canadian tax return. Income earned in another country must be converted into Canadian dollars on your Canadian return.

In most cases, if you earn income in or from another country and pay income tax to that other country, you will receive a foreign tax credit in Canada to ensure that you are not double-taxed.

> Example
>
> You are a resident of Canada. You worked for a couple of months in the United States and earned employment income there. You paid C$10,000 in US income tax. You also report the income on your Canadian tax return and are initially subject to C$12,000 tax in Canada.
>
> On your Canadian tax return, you would report the income that generates the liability for $12,000 of tax, along with a $10,000 foreign tax credit for the US tax, meaning that you would only pay $2,000 net tax in Canada.
>
> (There may be adjustments in the foreign tax credit calculations; the above example is straightforward and does not require the adjustments.)

In some cases, you will be taxed in Canada on the foreign-sourced income, but not taxed in the other country because of Canada's tax treaty with the other country. For example, under many treaties, if you have a capital gain on the sale of a foreign investment, you can be subject to tax in the other country only if the investment is real estate located in that country, or shares in a corporation (or interests in a trust or partnership) whose value is derived mainly from real estate in that country. Otherwise, the capital gain can be taxed in Canada but not the other country. If you carry on a business, you will normally not be taxed in the other country unless it is carried on through a "permanent establishment" in that country. Of course, not all treaties are the same, and each one needs to be considered carefully to determine the Canadian and foreign tax exposure.

## Not resident in Canada

If you are not resident in Canada, you are subject to tax only on Canadian-sourced income.

First, you are subject to the regular "Part I tax" at graduated tax rates (the same as apply to residents of Canada) on the following types of income:

- Income from employment carried on in Canada;
- Income from a business carried on in Canada; and
- Taxable capital gains from disposition of "taxable Canadian property", which includes Canadian real estate, property used in a business carried on in Canada, and shares in certain corporations (or interests in trusts or partnerships), where the value of the share (or interest) is derived primarily from Canadian real estate or Canadian resource properties.

For the above types of income, you will file a Canadian tax return and, as noted, you will pay the same graduated tax rates that apply to residents. In some cases, a tax treaty will exempt you from Canadian tax. For example, Canada's tax treaties generally provide that you can be taxed in Canada on business income earned in

Canada only if it is earned through a "permanent establishment" that you have in Canada.

Second, you may be subject to "non-resident withholding tax" on certain types of passive investment income, such as dividends, rent, royalties and income from Canadian trusts (interest paid at arm's length is no longer subject to this tax since 2008, unless it is "participating" interest, based on profits or cash flow). In such case, a 25% withholding tax applies, which the payer of the amount must withhold and remit to the Canadian government on your behalf. You do not file a Canadian tax return and the regular Part I tax does not apply. The withholding tax is simply your final Canadian tax liability on that income.

However, the 25% rate is often reduced by treaty. For example, the withholding rate for dividends from a Canadian corporation is typically lowered to 5%, 10% or 15%, depending on the treaty and the level of shareholdings of the non-resident in the corporation.

In some cases, you can elect to have passive income reported on a tax return under the regular "Part I tax" instead of being subject to the withholding tax. For example, if you earn rental income from a Canadian rental property, you are normally subject to the 25% withholding tax on the **gross** amount of the rent (and Canada's tax treaties generally do not reduce this rate). However, if you elect to file a Canadian tax return and be taxed under the regular Part I rules, you will be subject to the graduated tax rates on your **net** rental income (gross rent minus applicable expenses). In most cases, deducting expenses means it makes sense to make the election as the Part I tax on your net rental income will normally be much less than the 25% withholding tax on your gross rental income.

## Meaning of residence

If you are resident in Canada under Canadian law, but also resident in another country under its law, and Canada has a tax treaty with that country (Canada has over 90 such treaties), then the treaty will have "tie-breaker" rules to determine which country you are resident in (generally based on which one you have closer ties to). If such a rule applies, the Canadian Income Tax Act has a specific rule that says that if the treaty makes you resident in the other country, you are deemed to be a non-resident of Canada for Canadian income tax purposes. So, as well as determining whether you are resident in Canada, you have to determine whether such a treaty "tie-breaker" rule applies.

The primary or most important residential ties to a country are:

- Location of your home;
- Where you (and your spouse, if married) are physically present; and
- Where your dependents, like your children, are physically present.

Secondary residential ties include:

- Location of your personal property (such as furniture, cars, other vehicles, boats);
- Memberships in recreational or religious organizations;
- Economic ties such as where you are employed or carry on your business, hold bank accounts, retirement savings plans, credit cards, and trading accounts;
- Landed immigrant or permanent resident status under immigration laws;
- Medical or health insurance;
- Your driver's license; and
- Your citizenship.

Note that your citizenship is not itself determinative. That is, you can be a Canadian citizen and non-resident for income tax purposes, or a citizen of another country but resident in Canada for tax purposes.

Also, although physical presence is important, you could be physically present in another country but remain resident in Canada for tax purposes. For example, if you have lived in Canada all of your life and your employer sends you to work in an office in another country for a year, and you expect to return after the year, you will likely remain resident in Canada for that entire year.

Although there is no bright-test in the factual residency determination, there are some deeming rules that apply in limited circumstances. For example, if you "sojourn" in Canada for 183 days or more in a year, you are deemed to be resident in Canada for the *entire* year. "Sojourn" means to visit temporarily, such as visiting to study or work, or visiting on a vacation.

## UPDATE ON EMPLOYEE STOCK OPTIONS

Most stock-option benefits are only one-half taxed. That is, although the entire benefit is included in your income, one-half of the benefit is normally deducted in computing your taxable income.

As discussed in our August 2019 Tax Letter, the government recently proposed to restrict the one-half deduction. It proposed that only $200,000 worth of stocks under an option would qualify for the one-half deduction, each year. Benefits above the $200,000 threshold would be fully taxable. However, the one-half deduction would continue to apply to all stock options of employees of smaller, start-up corporations, including Canadian-controlled private corporations.

The proposals were scheduled to apply to options granted after 2019. However, on December 19, 2019, the Minister of Finance announced that more time was needed to determine the scope of the small, start-up corporations that would continue to benefit from the one-half deduction rule. As a result, the proposals are not yet applicable, and the new application date and more details will be announced in the 2020 Federal Budget.

## AROUND THE COURTS

### Car Allowances Taxable

In general terms, a car allowance provided by an employer to an employee is **not** taxable if it is reasonable, but is taxable if it is unreasonable. Furthermore, a special rule in the Income Tax Act says that a car allowance is deemed to be unreasonable if the allowance is not based solely on the number of kilometres driven in the course of employment. In other words, if the allowance is not based on such kilometres driven, it is taxable to the employee.

In the 2018 *Positano* case, the taxpayers were employed in a family snow-plowing business. One of their duties was to do "snow runs", under which they would drive to streets and neighborhoods to determine whether snow plowing would be needed. The brothers were paid a car allowance for the snow runs, which were based on *estimated* travel and *average* travel distances throughout the year. The CRA held that the allowances were taxable because they were

not based solely on the number of kilometres driven in the course of employment.

The taxpayers appealed to the Tax Court of Canada, but the Court upheld the CRA assessment. The Court held that an estimate was not enough to constitute a reasonable vehicle allowance. Rather, a reasonable allowance had to be based on actual kilometres travelled.

*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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