Death... and Taxes

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There are many steps one can take to defer taxes, but when it comes to death, it's time to pay the piper. With some exceptions and planning options (discussed below), you are obligated to pay taxes resulting from death. Although nobody likes to pay tax, it is important to recognize that we all have to pay our share. That doesn't mean, however, that you should pay more tax than you are required to by law. In the discussion below, you will find an overview of common strategies that minimize tax on death, so you can pass on as much of your estate as possible to your family.

But first an important caveat: Next to matrimonial litigation, estate litigation can be the most vicious and the cost of funding court battles between beneficiaries is often borne by the estate. So as important as saving taxes is, the importance of having a well thought-out comprehensive estate plan cannot be over-emphasized.

The spouse/common law partner rollover

Assets transferred between spouses, which includes common-law partners, normally transfer at cost, so that no gains are triggered on the transfer. So to the extent that assets have appreciated in value–that is, so that there are accrued but untaxed capital gains on them–consider leaving these assets to your spouse, common-law partner, or to a qualifying spouse or common-law partner trust. That way, the property "rolls over" to your spouse/common-law partner (or trust) at cost without triggering immediate tax. Other¬wise, the general rule is that assets you own at death will usually be deemed to have been disposed of at their fair market values at that time, triggering all accrued untaxed gains and subjecting them to tax.

Obvious candidates for the rollover include real estate, shares of a corporation, investments that have gone up in value, and so on. In order to defer "death tax", shares of a family business are often left to a spouse or common-law partner, or a spouse/common-law partner trust. One important consideration – if your shares are qualifying "small business corporation shares" and you will have unutilized capital gains exemption available at your death, you will generally want to plan to trigger enough capital gains on them to fully use up the exemption.

Note that there is also an exception to the general rule where qualifying farm or fishing property is transferred to children or grandchil¬dren. This type of transfer also qualifies for roll-over treatment. Again the consideration noted above applies if there is unutilized capital gains exemption available for use.

The transfer is usually provided for in your will or via a specific beneficiary designation where this is permitted, such as with RRSPs, but can also be done via the estate in the absence of any such provision. In this case your executor would simply transfer the property to your surviving spouse or common-law partner in satisfaction of their entitlement under the will.

Accessing the rollover by leaving property to a spouse or common law partner trust, as opposed to leaving it to your spouse or common law partner directly, may be the preferred route in second marriage situations where there are children of a first marriage that you want to have inherit your property after the death of your spouse or partner. That way your spouse can have access to the trust property while he or she is alive, with the remainder of the property in the trust passing to your children on his or her death.

Don't forget that gains on a vacation home, or other second property, are no longer eligible for the principal residence exemption, so if a second property is not left to a spouse or common-law partner, there will likely be capital gains tax on its appreciation as well.

The same logic applies to RRSPs and RIFFs: if they are left to a spouse or common-law partner, a roll-over applies; otherwise, the funds paid out are included in the income of the deceased for the year of death. Of course, it is possible that a spouse or common-law partner will pass away before the testator or that the latter is divorced, unmarried, or otherwise without a spouse or common-law partner. In this case, there is another tax-reducing opportunity: if a child or grandchild who is "financially dependent" is designated as beneficiary under the plan, special rules tax the registered plan proceeds in the hands of the child or grandchild–who will probably be in a lower tax bracket than the decedent–instead of them being added to the decedent's income in the year that he or she passes away.

Although a tax-free savings account ("TFSA") is not taxable on death, the holder can roll the plan over to their spouse or common-law partner when they die by designating the spouse or common-law partner as the beneficiary. By doing this, the spouse basically takes over the TFSA and does not have to contribute the funds themselves to a new plan and use up their TFSA room.

If qualifying small business corporation shares (or farm or fishing property) eligible for the lifetime capital gains exemption–of $848,252 for 2018–are held, a number of options will be available. If the exemption is available, you will generally want to use it up by the time you pass away. Any remaining unutilized amount should be used up on death by ensuring that sufficient capital gains are triggered on qualifying property. This can be done even if the shares are left to a spouse or common-law partner, because of a special rule that allows an individual to "elect into" a capital gain on a property-by-property basis (e.g., one or more shares of a corporation). Also, the surviving spouse is potentially eligible for his or her own capital gains exemption. If it is expected that, after death, there will be future appreciation in the shares that will more than eat up the surviving spouse's capital gains ex¬emption too, it may be a good idea to consider leaving at least some shares to children (or grandchildren) if it is intended that they remain within the family. This could be done before death through an "estate freeze" reorganization as well.

Life insurance

The proceeds of a life insurance policy payable on the death of the insured will not produce taxable income to either the deceased or a beneficiary. The designation of a life insurance beneficiary may be made in the will or in a document outside the will. Even where the designation is made in the will, it can be drafted such that the proceeds will not form part of the estate (which means savings on probate fees and protection from creditors of the estate).

Most people leave everything to their spouses, with the children inheriting it on the death of the last surviving parent. Because of the spousal roll-over, there is often little or no tax liability arising on the death of the first spouse. But because there generally aren't roll-overs for transfers of property from parents to their children, huge unexpected tax liabilities can result on the death of the last surviving parent. If there won't be sufficient cash available in the estate at that time to pay the tax without selling assets that the children want to keep, consider buying life insurance to fund the liability. Obviously buying the insurance when you are younger and healthy is better than leaving it until a time when it might be a lot more costly or even unavailable.

Income splitting using an estate

The estate of a deceased person is treated as a separate taxpayer. In the past, testamentary trusts were taxed at graduated rates, just like individuals, which allowed planning through sometimes multiple trusts for lower-income

spouses and children or grandchildren to "income split" and take advantage of the lower tax brackets of these individuals to lower the overall family tax burden. Starting in 2016, however, only the estate of the deceased individual will be considered a "graduated rate estate" which is taxed at graduated rates, and only for the first 36 months following death. All other testamentary trusts are now taxed at the top marginal rate (i.e., 33% for federal purposes). However, income splitting for the first 36 months using a graduated rate estate remains a viable tax planning opportunity.

RRSPs and RRIFs

Immediately before death, the owner of an RRSP/RRIF is deemed to have received as income a sum equal to the fair market value of all of the property of the RRSP for tax purposes. The general rule is that all of this income is taxed in the terminal tax return of the deceased. A major exception to this general rule is where the annuitant designates his or her spouse as the beneficiary/successor of the RRSP/RRIF—in such a case, the plan can be transferred to the spouse (or common-law partner) without incurring a tax bill. However this exception only applies to spouses and common law partners; it does not apply to children.

TFSAs

Where an individual has a TFSA at the time of death, the tax-free nature of the plan ceases immediately before death. There is no income inclusion for the deceased, but future earnings in the plan become taxable from the time of death onwards. However, provision is made for the "survivor" (the person who was the spouse or common-law partner of the deceased at the time of death) to become a successor planholder, in which case the plan does not cease at the time of death of the deceased. Even where the surviving spouse or common-law partner is not a designated survivor, there is provision for a rollover to that person's TFSA.

As with RRSPs and RRIFs, making a TFSA directly payable to a named beneficiary will save on probate fees. Note, however, that, unlike the situations with RRSPs and RRIFs, to date not all provinces have amended their laws to allow a testamentary beneficiary designation of a TFSA to be made outside of the testator's will. So depending on your province, you may have to make this designation in your will instead of in the plan.

RESPs

Given the incentives, parents (or grandparents) should be encouraged to establish a registered education savings plan ("RESP") for their children (or grandchildren). Where the children are minors, it will be especially important to address the issue of any RESPs of which the testator is the subscriber in the will.

Perhaps because of their similarity to RRSPs, there is some confusion as to the treatment of RESPs at the death of the subscriber. Where an RRSP planholder has named one or more beneficiaries, the proceeds will not form part of the deceased planholder's estate, but rather will flow directly to the named beneficiaries, thereby avoiding probate and the creditors of the deceased. In contrast, while a subscriber of an RESP must name one or more beneficiaries, the fact that beneficiaries have been named does not stop the RESP from forming part of the estate of the deceased subscriber (and, as such, it will be subject to probate fees and credi¬tors of the deceased).

If there is no express direction in the will of the deceased regarding the RESP, the right to a return of the contributions made to the plan will devolve to the executor and ultimately those contributions will form part of the residue of the estate to be dealt with according to the general residuary provisions of the will. This will probably not be the intention of the subscriber, but, even if it is, the issue should be expressly addressed in the will so as to ensure that the designated beneficiaries do not have the impression that the executor acted improperly in collapsing the plan.

An RESP may be dealt with in the will in a number of ways. For instance, a grandparent may wish the parent of the beneficiary to become the succeeding subscriber. Alternatively, thought may be given to having the estate become the succeeding subscriber.

Debt forgiveness

If someone is financially indebted to an individual and the individual wishes to forgive the debt, it is best to do this in the will. If the individual forgives the debt before he or she dies, there will be adverse tax consequences to the debtor if a debt was investment- or business-related (that is, the interest was potentially deductible to the debtor).

Charities

If the testator plans to make large charitable donations from his or her estate, it may be advisable to receive professional advice beforehand, as there are a number of tax planning opportunities and pitfalls here.

Probate fees

No discussion of estate planning would be complete without a brief mention of probate fees (or, as it is referred to in Ontario, "estate administration tax"). In essence, probate planning is aimed at reducing the value of the estate that passes to the personal representa¬tive--probate fees are levied based on the value of the estate, so the lower the value of the estate, the lower the probate fees that will be pay¬able. Reducing the value of the estate can be achieved through the use of multiple wills and a variety of will substitutes. These strategies cannot be discussed in depth here. It should be noted, however, that many of the more popular probate planning techniques (such as transferring assets to an alter ego trust or into joint tenancy with the intended beneficiary) present significant potential pitfalls, not the least of which is that they can hinder effective tax planning, such as the following:

- adding a joint owner to assets will result in a disposition for tax purposes, accel¬erating the recognition of any accrued capital gains, and potentially triggering the income attribution rules where the joint owners are spouses; and
- transferring assets to an *alter ego* or joint partner trust raises a host of tax issues, such as the fact that such trusts are taxed at the flat rate applicable to *inter vivos* trusts rather than the marginal rates applicable to individuals, and that any capital gains or losses realized on the deemed disposition of assets held in these trusts will be segregated from gains or losses taxable to the deceased in the year of death.

Also note that adding a person as a joint owner on assets comes with non-tax related consequences. For example, when someone is added to a bank or investment account as a joint owner, it remains subjective what the original owner's intention was. Is the new owner supposed to inherit the account after the original owner dies? Was the new owner merely added to help manage the original owner's finances (similar to a Power of Attorney)? Or was the new owner added to hold the assets in-trust for the estate's beneficiaries after the original owner dies?

Also, adding a person as a joint owner means giving up at least some degree of control of the asset and possibly some degree of financial independence. If they are added as joint owner to a bank account, for instance, the joint owner typically has full control of the account and can drain it at will. In the worst case, you could end up with insufficient funds for your retirement, particularly given that people are living longer these days.

Similarly, leaving aside possible tax issues, transferring a business to children or grandchildren outright to avoid probate fees means giving them control of the business. For this reason an estate freeze may be a better option to consider, as it can be structured in such a way to allow you to retain control while giving your children or grandchildren the future growth.

For these and other reasons, probate planning should not be undertaken without professional guidance and should be part of your overall estate plan.

Rights or things return

In computing a taxpayer's income for the year that they died, the amount of any interest, rent, royalty, annuity (other than an annuity contract deemed to be disposed of on death), employment income, or other amounts payable on a periodic basis that were accruing but were not due at the time of death, are brought into income.

However, instead of including the value of "rights or things", which if disposed of by a taxpayer prior to his or her death would have been included in

computing income, in the terminal return of the deceased for the year of death, the executor may elect to file a separate "rights or things" tax return for this portion of the deceased's income. Such a return is a separate return of the deceased, which means that personal tax credits may be claimed a second time with respect to this type of income.

Estate freezes

The shareholdings in a corporation can be restructured to effect what is known as an "estate freeze", whereby the value of the interests of the existing shareholders is "frozen" at their current amounts, with the future growth in value of the company accruing in the hands of others – typically children of the current shareholders.

The basic planning involves the existing shareholders exchanging their growth common shares for fixed value preferred shares on a tax-deferred roll-over basis. Once done, the value of the corporation is reflected in the value of the preferred shares and new growth common shares can be issued for a nominal amount.

Partial freezes are also possible, with only some of the common shares being frozen. These are a little more complicated as the common shares could retain significant value, which will affect the issue price of any new common shares issued, assuming shares of the same class are used.

Control of the corporation may be retained through making the freeze shares voting and ensuring there are sufficient votes on them to outvote the new common shares that will be issued. The freeze shares are also generally made redeemable, in order to allow the shareholders to access their capital down the road if needed. This also allows a degree of control, although in an all-or-nothing sort of way, as in a dispute the existing shareholders can require the company to buy them out, which would likely bankrupt the company at least in the early years after the freeze. A shareholder's agreement might also be a good idea to consider if maintaining control is a concern.

The freeze shares can also provide for the payment of non-cumulative discretionary dividends to allow the shareholders to receive income from the corporation should this be desired either immediately, or in the future.

When considering a freeze, it's important to not freeze too early. Otherwise you could end up running out of cash. There are ways to unfreeze, or thaw, a freeze, but it's better to avoid having to do so in the first place by considering your life expectancy, health, and cash requirements in retirement before freezing.

These are just some of the considerations involved in an estate freeze and it's important to seek professional advice before proceeding to make sure your particular situation and needs are taken into account.