

## Death or Taxes – Which comes first?

It is often said that the only two sure things in life is Death and Taxes. Modern medicine has made great strides in deferring both of these items, but one will not happen without the other. Unfortunately until the “Death” problem is solved, taxes at death continue to be an issue.

Canadian tax legislation does not impose an “inheritance tax”, but certain things happen on the death of a taxpayer, and it falls on the shoulders of the Executor to insure that the proper documentation and steps are followed to minimize the income tax bite.

When a taxpayer dies, income tax legislation deems that all assets of the taxpayer are disposed of just prior to death thereby creating a testamentary trust. It is at this point that the Executor takes over the management of the financial affairs of the taxpayer and the estate.

There are three different types of tax returns that may be required.

An “ordinary” tax return, often referred to as the final return, is filed as of the date of death. This return includes all income from January 1<sup>st</sup> up to the date of death such as employment and investment income. This return is due April 30<sup>th</sup> of the following year or 6 months from the date of death, whichever is the later.

Elective returns are also T1 returns. These type of returns consists of income earned from “Rights or Things” or business and trust income with non-calendar year fiscal periods. Rights or Things are made up of income that is owed to the taxpayer at death, but is not paid until after death.

T3 Trust returns result from the testamentary trust created on death. The trust holds the assets of the estate until such time as the funds are distributed to the beneficiaries of the estate. The trust also has the option of declaring income earned within the trust and paying the taxes or passing the income through to the beneficiaries. This will result in each beneficiary paying the income taxes at their own marginal tax rate, which may be beneficial.

The responsibility for completing and filing the returns for the deceased taxpayer and estate fall with the Executor. In many cases the Executor is a family member or friend and is not aware of many of the options and requirements of the position, therefore professional advise should be sought out as soon as possible in order to take advantage of various options and choices that can be made in order to reduce the tax impact.

### **What Goes Where?**

**Final Return** – The final return for the deceased taxpayer is completed as “normal”, with a couple of twists. The date of death is reported on the T1 return, however, for the purposes of non-refundable tax credits and pension income-splitting provisions, amounts are not pro-rated and the date of death is deemed to be December 31<sup>st</sup>.

**Elective Returns** – As previously mentioned, elective returns are T1 returns used to file income from Rights or Things. For the purposes of elective returns, full personal exemption amounts for each elective return may be claimed. For tax planning purposes, this will assist in creating additional tax-exempt zones.

**Trust Return** – A T3 Trust return is used to maintain and report income earned by the trust prior to full distribution to the beneficiaries. A T3 return is not required to be operated on a calendar year basis and may continue in operation for many years before final distribution and winding up.

**Employment income** earned and received up to the date of death is reported on the final return. This will include any automobile allowances, employee benefit plans or any other type of employment income earned and paid.

Vacation pay and employment income earned but not paid as of the date of death may be reported one of the elective Right and Things returns. Employers are not required to break the income down to “before and after” death amounts, but it will usually be beneficial to do so.

**CPP and OAS Benefits** are paid up to and including the month of death. These amounts will be included in the taxpayers’ final return. As these payments are normally paid at the end of each month, the amount paid for the month of death would qualify as a Rights or Thing and be eligible for reporting on an elective return.

**Interest income** is reported on personal tax returns on an accrual basis. Therefore in the year of death, interest income accrued up to the date of death is reported on the Final return, while interest earned after the date of death is reported on the T3 testamentary trust return.

**Dividend Income** is reported on personal tax returns as received. In the year of death, three different factors must be taken into account to determine which return dividend income is reported on.

Dividends are income to the shareholder on record when declared, or the date of record. All dividends received prior to death are reported on the Final return. Dividends that are declared prior to death, but not paid until after death, are eligible to be reported on an elective Rights or Things T1 return.

Dividends declared and received after the date of death will be reported on the T3 testamentary trust return.

**Capital Gains/Losses** are (surprise) handled differently again. Capital assets that are transferred to a surviving spouse are transferred at the original adjusted cost base. This has the effect of deferring any potential capital gain or loss until such time as the surviving spouse disposes of the asset. In the event that there is no surviving spouse, the capital assets are deemed disposed of at the date of death.

This results in a deemed disposition at fair market value being reported on the Final return of the taxpayer. The testamentary trust is also deemed to have acquired the capital assets at FMV. Any subsequent gains or losses resulting inside the trust will be taxed in the hands of the trust or alternatively, passed through to the beneficiaries by way of the T3 return.

### **Registered Retirement Savings**

As we are all too aware, CRA can be very patient when it comes to taxation. This is no more prevalent than on the death of a taxpayer and the tax treatment of Registered Investments.

On death, RRSP and RIF investments can be transferred to a surviving spouse and incorporated into their individual plans. There are also some provisions for transfers to dependant children of the taxpayer. The tax implications come into effect on the death of the last spouse.

Registered investments such as a RIF or RRSP, are deemed disposed as of the date of death. As registered investments they have enjoyed continued growth and tax deferral treatment over the years. Now it is time to bring the retirement savings of the taxpayer back into income.

Unfortunately, this happens all at once. The graduated tax rates within the ITA result in a high marginal tax rate being applied to the retirement savings. Assuming that the registered retirement savings has a value of \$200K, the result is a marginal tax rate of 46.4% (Ontario) being applied.

As always, proper pro-active planning and structuring of your financial affairs can help in reducing income taxes.

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