POST MORTEM ESTATE PLANNING

A. Introduction

Estate planning strategies are available to the personal representatives of the estate of a deceased. The strategies are far more limited than those available to a testator at the time of the preparation and execution of a will. Most strategies have income tax implications, and a better way of describing these strategies may simply be “Minimising Tax at Death”. These strategies allow the personal representative of the estate of a deceased to file an election within a prescribed time under the Income Tax Act [Canada] including ones related to trust year ends, roll-over elections of capital assets to a surviving spouse or spousal trust, using previous year capital losses against terminal return income, filing of multiple tax returns and taking advantage of any unused qualified small business or qualified farm properties capital gains exemption. The strategies provide personal representatives with options that may reduce tax liability of the deceased and the estate. This paper briefly describes some of the strategies. All references herein to section numbers are to the Income Tax Act [Canada].

B. Multiple Tax Returns

More than one tax return may be filed in the year of death on behalf of a deceased taxpayer

The personal representative is required to file a final tax return from January 1 of the year of death to the date of death, sometimes referred to as the terminal return.

In addition, the personal representative has options for filing of tax returns after the taxpayer's death.

In addition to the final return the personal representative can file as many as three optional returns. These optional returns allow for some personal credits to be claimed on each return [including, basic personal amount, age amount, spouse or common-law partner amount, eligible dependant amount, infirm dependant amount] and for some amounts to be split between returns [disability amount for the deceased, disability amount transferred from a dependant, interest on student loans, tuition and education amounts for the deceased and transferred from a child, charitable donations, cultural, ecological and Crown gifts and medical expenses].

The optional returns include:

1. Where the taxpayer carries on a business in a taxation year and dies in that year the personal representative can file an optional return.

If, after the fiscal period of the business that ends in the year, another fiscal period of the business ends in the year as a result of the taxpayer's death, then subsection 150(4) of the Income Tax Act allows the legal representative the option of filing an additional return of income for the income earned during that short period between the end of the first fiscal year and the date of death. The return for the short period is separate and treated as if the taxpayer were another person whose only income for the year was the income earned in the short period.

2. Where a taxpayer was an income beneficiary of a testamentary trust and dies after the end of a taxation year of the trust, but before the end of the calendar year in which the taxation year ended, a separate tax return can be filed for that short period pursuant to paragraph 104(23)(d). Ordinarily, income from the trust for the period between the end of the taxation year and the time of death is included in computing the income for the taxation year in which the individual died. However, this provision allows the personal representative of the deceased taxpayer to file a separate return for this short period as if the taxpayer were another person for the amount of income earned from the trust during this short period.

3. Another option is provided under subsection 70(2).

This provision allows for the personal representative of an estate to elect to file a rights or things return, which allows for the realizable or disposable value of rights or things, other than capital property, to be included in a separate tax return and reported as if the taxpayer were another person, and the person's only income for the year were the value of the rights or things. Rights or things include matured unpaid salary and wages or commissions, uncashed matured bond coupons, CPP benefits, vacation pay, declared but unpaid dividends and employment insurance benefits.

The time period for electing and filing separate returns under 70(1), 150(4) and 104(23)(d) is generally the later of April 30 of the year following death or six months following the date of death.

The rights or things return however, may be filed the later of one year from the date of death or 90 days after the mailing of any notice of assessment in respect of the tax return of the taxpayer for the year of death.

The difference between periodic payments, reported under 70(1) and rights or things, reported pursuant to 70(2) can be confusing. Interpretation Bulletin IT-212R3 provides that where there is a genuine doubt whether income earned before a taxpayer's death is a periodic payment or a right or thing, its treatment is generally to be resolved in favour of the taxpayer.

Periodic payments include amounts accruing but not yet due as at the date of death. Periodic payments are therefore separated into amounts taxed in the hands of the individual prior to death [amounts accruing prior to death] and amounts taxed in the estate [accruing after death].

C. Flexible Year Ends

Paragraph 104(23)(a) of the Income Tax Act provides that the taxation year of a testamentary trust is the period for which the accounts of the trust are made up for purposes of assessment under the Income Tax Act.

This allows for some flexibility in declaring a trust period. The period may not however, exceed 12 months, and no change may be made to such a period, once made, without the concurrence of the Minister. Trustees may choose any date within 12 months of the date of the testator’s death for the taxation year end of the trust. The year end need not correspond with the calendar year.

Choosing a year end can be a complex endeavour. If chosen well it may be used to reduce the tax burden of a trust and increase the assets available for the beneficiaries. It may be used by a trustee to channel income to a beneficiary during times when the beneficiary may want to include additional income and hold it back when it is advantageous to do so.

It can also be costly if the year end is poorly chosen. For example, where a capital loss is available to the estate, the trustee wants to be able to declare this loss in the first year of the trust so it can be offset against any capital gain in the deceased's final year return.

Fullerton v. M.N.R. provides an example of a poorly considered year end. The court in that case at paragraph 13 stated: "Paragraph 104(23)(c) of the *Act* clearly states and the authorities have confirmed that the section establishes that the taxation year for which the beneficiary of a testamentary trust must include the benefits received will be the taxation year of the trust during which the benefits were paid."

When planning the payment of income from the trust, the trustee has to keep that in mind. [e.g. the trust's (estate's) fiscal year was Feb 2, 1978 to Feb 1, 1979. Income was paid to the beneficiary in both her 1978 and 1979 taxation year. The trust paid income to the beneficiary in its 1979 taxation year. All of the income was taxed to the beneficiary in her 1979 return because the court found that to be the appropriate definition of s. 104(23)(c).]

Where a testamentary trust is being wound up, the trustees can adopt the date of wind-up as the year end without seeking permission from the minister to vary the year end of the trust.

First edition June 8, 2004.

Generally, where permission is sought to change the year end of a trust, the minister will only accede to the request on the basis of sound business reasons. The reduction of taxes is not considered a sound business reason.

Again, the choice of a year end can be critical and should only be made after thorough consultation with an experienced estate accountant.

D. Harvesting Capital Losses

The Income Tax Act allows for deductions in the year of death under subsection 111(2). That subsection redefines deductible losses for living persons which are set out in subsection 111(1). It provides as follows:

111(2) **Year of death** – Where a taxpayer dies in a taxation year, for the purpose of computing the taxpayer's taxable income for that year and immediately preceding taxation year, the following rules apply:

(a) paragraph (1)(b) shall be read as follows: "(b) the taxpayer's net capital losses for all taxation years not claimed for the purpose of computing the taxpayer's taxable income for any other taxation year"; and

(b) paragraph (1.1)(b) shall be read as follows: “the amount, if any, by which:

(i) the amount claimed in paragraph (1)(b) in respect of the taxpayer’s net capital losses for the particular year exceeds the total of

(ii) all amounts in respect of the taxpayer’s net capital losses that, using the formula in subparagraph (a)(ii), would be required to be claimed under paragraph (1)(b) for the particular year to produce the amount determined under paragraph (a) for the particular year,

and

(iii) all amounts each of which is an amount deducted under section 110.6 in computing the taxpayer’s taxable income for a taxation year, except to the extent that, where the particular year is the year in which the taxpayer died, the amount, if any, by which the amount determined under subparagraph (i) in respect of the taxpayer for the immediately preceding taxation year exceeds the amount so determined under subparagraph (ii)

This rather complex set of provisions, as they relate to capital losses, can be interpreted as follows: During a taxpayer’s life, capital losses are usually only deducted against capital gains. Since capital losses can be carried forward indefinitely a taxpayer may, therefore, die with a substantial amount of unused capital losses on hand.

Section 111(2) allows such accumulated losses and other capital losses arising as a result of subsection 70(5), [deemed disposition of capital property on death], to be offset against the taxpayer's income [with some adjustments] during the year of death and the year before the year of death.

There is no difference between the treatment of the net capital loss applied to the assets going into the estate from the treatment of those assets going directly to the trustee of a separate trust. The focus of the net capital loss deduction is for the deceased and the deceased's various tax returns, not the trust (estate or otherwise).

In CCRA's 2001 "Deceased's Person's" guide, it states that the net capital losses can be used to reduce capital gains in the last year of the deceased [minus any capital gains deduction claimed during the deceased's lifetime] and also reduce the capital gains from the two previous returns of the deceased. Alternately, if there is a net capital loss in the year of death, the trustees can use this to reduce the income for the year of death return (after reducing the capital loss by any capital gains exemption taken in the deceased's lifetime).

Direct Transfer to Trustees

Where there is a qualifying spousal trust, the trustees have the option of rolling an asset directly into the trust or triggering the capital gain or loss under subsection 70(6.2), before transferring the asset from the deceased to the trust.

This can be done on an asset by asset basis. Often there will be significant capital gains in the deceased's last year because of the deemed disposition rules under subsection 70(5). The deceased's representative can file an election to trigger these gains and losses at the time of filing the final years return.

Capital Losses In the Estate

Where there is a capital gain in the year of death, the trust is allowed to offset any net capital loss in its first year against the gain in the year of death of the taxpayer. Great care needs to be taken in this case when choosing the trust's year end.

As an example assume the situation where a taxpayer dies in October of 2003. The trustee precipitously chooses a December 31 year-end. In the summer of 2004, the trust declares a capital loss. Because this is now, fiscally the 2nd year of the trust, the deduction is not available on the year of death return.

The trustees could have availed themselves of the flexible year end by designating the year end after the losses were triggered but did not do so. At this point requesting that the Minister approve a change of the year-end is unlikely to succeed because, as stated above, the Minister will only agree to a change in the year end of a trust for sound business reasons, which do not include the reduction of taxes. In this circumstance the trust is prevented from deducting the capital loss.

The choice of a year end can be critical and should only be made after thorough consultation with an experienced estate accountant.

E. Instalments on Capital Gains Taxes

Subsection 159(5) of the Income Tax Act provides for the payment of taxes on capital gains triggered by the death of a taxpayer to be made by equal annual payments, [not exceeding 10], plus interest. There must be sufficient security for the total amount for CRA to agree to the instalment plan.

Presumably, the reason for the deferral is the potential unfairness of requiring the estate to liquidate assets simply due to the deemed disposition at death rules. This deferral is only available to capital gains that are payable by the deemed disposition rules of the Income Tax Act.

Care should be taken to ensure that taxes are payable on capital gains and not income because the deferral is not available on income.

The rate of interest payable on the future instalment payments is the prescribed rate in effect at the time of the election. That rate remains in effect throughout the entire period of instalments, even up to the maximum 10 year period.

F. Enhanced Capital Gains Exemption

Taxable capital gains on shares of a qualified small business or qualified farm property are able to be reduced or eliminated by a $500,000.00 capital gains exemption.

The shares must be of a Canadian Controlled Private Corporation, of which, at the time of disposition of the shares all or substantially all [90%] of the assets are used in an active business carried on primarily in Canada. In addition, the shares cannot have been owned by anyone other than the taxpayer or a person related to the taxpayer throughout the period 24 months prior to death, and throughout that 24 month period more than 50% of the assets must have been used principally in an active business carried on primarily in Canada.

If the shares are left to a spouse or spousal trust they can be rolled over to the spouse. Alternatively, if there is room in the deceased's capital gains exemption then the personal representative may elect not to have the automatic rollover apply and to use up some or all of the remaining part of the exemption.

G. Principal Residence Exemption

An exemption is available for a capital gain otherwise attributable to the deemed disposition of a property that was ordinarily inhabited by a taxpayer at the time of death. This exemption need not apply to the main residence, but could include a cottage property. At the time of death a personal representative may face the decision as to which of two or more properties will be treated as the principal residence for tax purposes.

H. Other Strategies

Not all strategies concern tax minimisation. Some examples would include applications under the *Dependants Relief Act*, the *Trustee Act,* the *Marital Property Act* [*Family Property Act*] and *Employment and Income Assistance Regulations* to make provision for a dependant inadequately considered in the will, to vary a trust, or to create a self-starter trust.

First edition June 8, 2004.

I. Information in this Paper not Substitute for Legal Advice

This paper is intended as an introduction to this topic. It is not a substitute for specific legal advice tailored to a client's particular needs. Any person wishing advice on how to order their affairs, or those of a client, should contact a member of our Wealth and Succession Practice Group. This paper is also based on the laws of Manitoba, and while laws are similar from Province to Province, the content of this paper may not be accurate in other provinces.

J. Conclusion

Estate planning strategies are available for personal representatives of the estate of a deceased person. They generally involve elections available under the Income Tax Act (Canada) and decisions usually require a fairly in depth knowledge of that Act and its provisions. There is no substitute for seeking professional advice at the time, and a good estate accountant would provide valuable insight and assistance to ensure the appropriate decision is made to result in reduced tax burden.

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First edition June 8, 2004.

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Wealth and Succession Practice Group

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We regularly assist our clients in minimizing income taxes paid and structure special arrangements to improve the lives of the families, friends and community left behind. This involves estate freezes, corporate restructures, living trusts, tax planned wills, special trusts for disabled beneficiaries, estate administration, trust administration and pension fund administration.

We serve private individuals, local, national and international corporations, pension funds, trusts, trust companies, banks, planned giving departments and other institutional and non-institutional clients.

First edition June 8, 2004.