Death... and Taxes

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DEATH... AND TAXES

Death and taxes, it has been famously said, are life's only two certainties. To these might be added a third–a natural human reluctance to contemplate either, much less both simultaneously. Notwithstanding, death, like virtually every other significant human event, comes with its own set of tax consequences and obligations. This article summarizes some estate-planning tactics which will help ensure that the largest part of your estate as possible will go to your intended beneficiaries–rather than the Canada Revenue Agency.

The importance of the spouse/ common-law partner as beneficiary

To the extent that assets have appreciated in value–that is, so that there is untaxed capital gains–these assets should generally be left to the spouse or a qualifying spouse trust. That way, the property "rolls over" to the spouse (or spouse trust) without immediate tax. Otherwise, the assets will usually be treated as if they had been liquidated at current market values (an exception arises where qualifying farm or fishing property passes to children, grandchildren, and so on).

Obvious candidates for the rollover include real estate, shares of a corporation, investments that have gone up in value, and so on. Accordingly, in order to defer "death tax", shares of a family business are usually left to a spouse, or more likely, a spouse trust.

Don't forget that a second home is no longer covered by the principal residence exemption, so if this is not left to a spouse, there could 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 will pass away before the testator or that the latter is divorced, unmarried, or otherwise without a spouse or common-law partner. In which case, there is another tax-reducing opportunity: if a child or grandchild who is "financially dependent" is designated, special rules tax the RRSP inheritance in the hands of the child or grandchild–who will probably be in a lower tax bracket than the decedent–instead of being added to the decedent's income in the year that he or she passes away.

If qualifying small business corporation shares (or farm or fishing property) eligible for the enhanced capital gains exemption–of up to $800,000 (effective January 1, 2014)–are held, a number of options will be available. If the exemption is available, the individual will generally want to use it up by the time he or she passes away. This can be done even if the shares are left to a spouse, 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 exemption, it may be a good idea to leave 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, to meet the family's financial needs.

The principal residence exemption

Consideration should be given to leaving a residence to a beneficiary who will be eligible to claim the principal residence exemption on it. Keep in mind that married couples, together with unmarried children under the age of 18, are generally entitled to only one principal residence exemption among them. However, the principal residence exemption might be maximized, for example, by leaving the residence to an adult child who does not already have a principal residence.

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 tax and protection from creditors of the estate).

Low-bracket beneficiaries

Consideration should be given to leaving income-earning assets to low-tax-bracket beneficiaries, such as grandchildren, a low-income child (or his or her spouse), and so on. This is because income from bequests to high-income individuals will, of course, be added to their other taxable income, thus resulting in a significant tax exposure.

Income splitting

The estate of a deceased person is treated as a separate taxpayer; therefore, it can take advantage of low tax brackets, just like an individual. This means that, in effect, beneficiaries can "income split" with the estate. This opportunity has been made even more effective, due to a rule that an estate can choose to pay tax on income even though it is actually payable or distributed to beneficiaries. To take advantage of this rule, it is recommended that the will make it clear that the estate can continue for a number of years at least. For example, if the will simply leaves assets to beneficiaries "outright", some estate planning experts question whether this favourable tax break can continue longer than one year after death (after which the beneficiaries are normally entitled to a distribution of the property from the estate).

The following are some scenarios where the "estate split" may be realized; naturally, the degree to which an estate may split advantageously will depend on its size.

Spousal trusts

Spousal trusts are effective estate-planning tools for reasons that extend beyond tax planning. However, they may also be advantageous from a tax-planning perspective. Rather than leaving all assets to a spouse, a portion of the assets may be bequeathed to a trust for her benefit. Income earned by the trust may accumulate and be reported by the trust on a separate tax return at graduated rates. This may be advantageous where the income would otherwise be taxable to the spouse at top marginal rates. After its fiscal year end, accumulated income becomes capital and could be distributed as a tax-free capital distribution.

Trusts for children

Rather than bequeath the entire estate to a spouse and/or a trust for his or her benefit, part of the estate may be bequeathed to a separate trust for the benefit of the children. Assuming that the children are young and that the surviving spouse would have to discharge the expenses out of after-tax dollars, this may be an attractive alternative. The trust would also benefit from graduated tax rates on accumulating income not subject to the preferred beneficiary election. If the testator is concerned that the parent may require the funds, provision may be made for the parent to be a capital beneficiary and to receive the remaining trust property on the child reaching a certain age (e.g., age 25). This would enable the parent to use the income (and capital, if necessary) to finance a child's education, and to have the balance of the capital available to assist the parent.

College
New House
Education
Vacation
Retirement
Insurance
New Car

A Trust for each child

Rather than bequeath the entire residue of the estate to adult children, a portion may be bequeathed to separate trusts for the benefit of each adult child so as to enable part of the estate income to be reported on separate trust returns at graduated tax rates rather than being taxable at the top marginal rates of the children.

Trusts for grandchildren

Rather than bequeath the entire residue of the estate (after the death of the parents) to children, part of the estate may be bequeathed to separate trusts for grandchildren. Each trust would benefit from marginal tax rates and would be able to deduct income paid or payable to the grandchild or allocated to him or her by means of the preferred beneficiary election. Such a trust would enable the parents to use no or low tax dollars to pay for the children's annual expenses and to save up for their university education or to assist them in buying a home or a business. This would be preferable to bequeathing the assets to a child who would be taxable at the top marginal rate and would then use after-tax dollars to pay for his or her children's expenses.

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 tax

No discussion of tax planning the will would be complete without a brief mention of probate tax (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 representative--probate tax is proportional to the value of the estate, so the lower the value of the estate, the lower the probate tax that will be payable. 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:

- passing the bulk of a testator's assets outside his or her estate to the intended beneficiaries will mean foregoing the use of one or more testamentary trusts to engage in post-mortem income splitting;
- transferring assets into joint tenancy will result in a deemed disposition, possibly accelerating the recognition of capital gains; 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 testamentary trusts, 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.

For these and other reasons, probate planning should not be undertaken without professional guidance.

Note: The 2014 federal Budget proposed changing the taxation of estates and trusts significantly, primarily to remove the trust's ability to tax income at graduated rates, and taxing all income of the trust at the highest rate. As well, all trusts will need to convert to using a year end that coincides with the calendar year.