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Tax Planning the Will

It is generally recognized that everyone should make a will; it is, however, not always recognized that doing so can often be the occasion for some fruitful tax planning.

The Importance of the Spouse 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.

To obtain tax deferral benefits on transfers to a spouse or common-law partner trust, the property transferred or distributed must vest in the trust within 36 months of the death of the person and the trust must be resident in Canada immediately after the vesting. A trust will be considered a valid spouse or common-law partner trust if it is created by the deceased's will, or by court order. The longer the lapse of time between the death of the transferor-spouse and the death of the beneficiary-spouse, the greater the tax advantage to be derived—whether the transfer is made directly to the surviving spouse, or to a spousal trust, the deemed disposition will be deferred until the death of the surviving spouse.

Obvious candidates for the rollover include real estate, shares of a corporation, investments that have gone up in value. Accordingly, to defer "death tax", shares of a family business are usually left to a spouse, or more likely, a spouse trust. However, there can be tax exposure even if the asset has not actually appreciated in value. An example of this would be a rental or other property on which depreciation claims have been made.

If qualifying small business corporation shares (or farm or fishing property) eligible for the capital gains exemption 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 deplete 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. Married couples and common-law partners, 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.

An individual may also be found to be disabled if he or she is **significantly restricted** in performing more than one activity for daily living and the cumulative effect amounts to being **equivalent to markedly restricted**. A disability is considered to be prolonged if it is anticipated to last for a continuous period of 12 months.

Life Insurance

Upon the disposition of a life insurance policy, the excess of the cash surrender value over the adjusted cost base will be treated as income in the hands of the owner of the policy. However, in the case of death, 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-Tax Bracket Family Members

Consideration should be given to leaving income-earning assets to beneficiaries who are in low tax brackets, 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.

Testamentary Trusts

A testamentary trust is a trust that is settled by an individual as a result of their death. Effective January 1, 2016, "testamentary trusts", which hitherto benefited from several tax preferences (including graduated rates and off-calendar year ends), ceased having access to such benefits, unless such trusts are "graduated rate estates", which are limited to a life span of 36 months from the date of death. Another qualification of a graduated rate estate is that there may only one per deceased.

An exception is also made for qualified disability trusts, which are trusts established for the benefit of a disabled beneficiary. Note that a life insurance trust will not qualify as a qualified disability trust.

Regardless of these changes, there remain some income tax benefits to using a testamentary trust. Primarily, this will involve the use of "estate fund" type trusts for "sprinkling" income splitting among beneficiaries. These trusts will give the trustee power to allocate among the beneficiaries. For example, testamentary trusts may still be used to allocate sufficient income to a beneficiary to fully utilize that beneficiary's graduated tax rates by making the income "paid or payable" to the beneficiary as a "top up" to that beneficiary's other taxable income. This may be advantageous for both adult and minor beneficiaries.

Other uses include trusts for spendthrifts; Henson trusts established to protect the access of disabled beneficiaries to provincial income support programs; trusts for U.S. residents or citizens for U.S. estate tax planning, trusts to protect against double probate of assets, and trusts to protect assets from credit or matrimonial claims made against the beneficiary.

RRSPs and RRIFs

Immediately before death, the annuitant of an RRSP is deemed to have received as income a sum equal to the fair market value of all of the property of the RRSP. The general rule is that all of this income is taxed as a benefit in the terminal tax return of the deceased (RRIFs are accorded a similar treatment). The first major exception to the general rule is where the annuitant designates his or her spouse as the beneficiary of the RRSP.

Generally, a spouse (or common-law partner) should be designated as beneficiary of an RRSP (or RRIF). Otherwise, the entire balance or value may be included as taxable income in the decedent's final (terminal period) return. However, before the spouse (or common-law partner) is designated as the beneficiary, consider the following questions:

- Does the spouse already have sufficient registered investments?

- Is the spouse the higher income earner?
- Is it probable that the estate would have reduced income, capital losses, or a loss carryforward to report in the year of death?

In certain circumstances, it may be appropriate to make the spouse the beneficiary to only a portion of the RRSPs or RRIFs.

Naming a spouse or another individual (rather than one's estate) will also serve to exclude the RRSP (or RRIF) proceeds from one's estate for probate purposes. This has a number of advantages, including saving on probate taxes, which are not insignificant in British Columbia and Ontario. Of course, it is possible that the spouse will pass away before the individual, or that the individual 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.

It is presumed in the first instance that a child/grandchild was not financially dependent if his or her income in the year preceding the death exceeded a specified amount. That presumption can be rebutted by factual evidence. The specified amount at which the presumption against dependence comes into play is the basic personal amount for the year preceding death, which amount is indexed for inflation. Thus, for a death in 2018, the child is presumed not to have been dependent on the deceased where the child's 2017 income did not exceed the 2017 basic personal amount of $11,635.

Where the child/grandchild was dependent by reason of mental or physical infirmity on a supporting parent/grandparent who died, the preceding year's basic personal amount used as a benchmark in the presumption of dependency is supplemented by the preceding year's disability amount (both as indexed). Thus, where the death occurred in 2018 and the child/grandchild was dependent by reason of mental or physical infirmity, the child/grandchild looks back to a 2017 amount of $11,635 + $8,113 = $19,748.

Shares and Partnership Interests

If shares of a corporation, or an interest in a partnership, whose value has appreciated, are held, and these assets are to be left to someone other than a spouse, it should be remembered that, in many cases, it will be advisable to undertake some rather complex tax manoeuvres within the first year of the estate; otherwise, there could be "double tax" exposure when the underlying corporation/partnership assets are sold off.

Unfortunately, many executors are not aware of these manoeuvres until it is too late—as stated, the deadline may be one year after the individual passes away. In this situation, it should be ensured that executors are advised to seek professional tax advice. This should generally be done whenever shares or partnership interests are left to someone other than a spouse, and have appreciated in value (a similar situation may arise when the surviving spouse who is the beneficiary under a spouse trust passes away). In addition, the will should give executors and trustees authority to make the various tax elections and designations that are required.

Donations

Effective January 1, 2016, greater flexibility is available in using the donation tax credit related to donations made by will and gifts by direct designation. The rules allow a donation to be allocated between the deceased and his or her estate where the donation is made by a graduated rate estate (or a former graduated rate estate within 60 months after death). In such case, the deceased may use the donation credit in the year of death or in the immediately preceding year. Alternatively, the estate may use the donation in the year of the donation, carry it back to any of its prior taxation years, or carry it forward for up to five years.

If an RRSP or RRIF names the estate of the deceased as beneficiary, the value of the RRSP, etc., is included in income of the deceased immediately before death, and if the proceeds are then donated to charity under the will, there is an offset of income by charitable donation credit. However, if the RRSP or RRIF names the charity as beneficiary, there is no donation credit for the estate. The death benefit under a life insurance policy is subject to the same inconsistency where a charity is the named beneficiary. A donation credit is permitted to the deceased in the year of death where a charity is named as the beneficiary of an RRSP, RRIF, TFSA, or life insurance policy.

The effective capital gains inclusion rate for donations of listed public securities and shares of private corporations to charitable organizations and public foundations is 0%.

Spouse and Common-Law Partner Trusts

A spouse trust can be an effective succession and estate planning vehicle. It combines the tax-deferral advantages of leaving assets to a spouse, with the ability to protect family interests. Where a successful business is involved, it is more usual to use a spouse trust rather than leaving the shares and other assets outright to the surviving spouse, in order to preclude the possibility of the surviving spouse changing the terms of his or her will (e.g., in the event of a remarriage). In addition, the appointment of suitable trustees may protect against mismanagement of the business or distributions which could jeopardize financially the viability of the ongoing business. Specifically, this could provide protection from the surviving spouse exercising retraction rights attaching to freeze shares (e.g., where an elderly surviving spouse has remarried and is under the influence of a spendthrift spouse).

Spouse trusts may be used for gifts during one's life or upon their death. In order to qualify for rollover treatment, the trust must provide that:

- the spouse is entitled to receive all of the income of the trust that arises before the spouse's death; and
- no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust (in addition, the capital property transferred or distributed to the spouse or spouse trust must vest indefeasibly in the spouse trust within 36 months of the taxpayer's death or, upon written application to the Minister within that period, within such longer period as the Minister considers reasonable in the circumstances. Further, the deceased must have been a Canadian resident).

Rights or Things

Where at the time of death, a person has "rights or things" which, if they had been realized or disposed of during the taxpayer's lifetime, would have been included in computing income, the value of such rights or things must be included in the final return of the deceased. Although the phrase "rights or things" is ambiguous, examples may include work-in-progress of a sole-practice professional, dividends that have been declared but not paid, unused vacation leave credits, unmatured bond bonus coupons, and so on.

The CRA has indicated that a bonus payable to an owner–manager of the corporation qualifies as a "right or thing", provided that it was declared before death. Where, however, the employer has a contractual obligation to pay a bonus annually or on some other periodic basis, but the bonus for the period has not been declared as at the date of death, the amount is considered to be a periodic payment of taxable income as usual.

In simple terms, rights or things can be thought of as amounts to which the taxpayer became entitled before the taxpayer's death and which, if collected or otherwise realized, would have formed part of the deceased's income.

Where there is doubt whether the nature of income is a right or thing, it is the CRA's policy to generally resolve the issue in favour of the taxpayer. As a general rule, it is preferable to have the amounts considered rights or things because the amounts can be taxable to the deceased's beneficiaries (and not the deceased) in the circumstances described below.

Where rights or things of a deceased taxpayer are distributed or transferred to beneficiaries within one year or within 90 days of the mailing of the notice of assessment in respect of the final return, whichever is later, the value of such rights or things may be excluded from the deceased's final return. Instead, the value of such rights or things may be included in computing the beneficiaries' income at the time those rights or things are realized (given the tax burden involved, the personal representative should not make the election without the beneficiary's consent; the personal representative should also verify that he or she has the power under the will to make the election).

There are two principal advantages of this tax rule. Firstly, the rate of tax payable on rights or things may be lower if they are transferred to the beneficiaries of an estate; that is, the total income may be spread over several beneficiaries resulting in a lower rate of tax. Secondly, the tax burden attached to the rights or things can be deferred until they are "realized" by the beneficiary. A dividend is "realized" when it is received by the beneficiary. Unpaid salary, vacation pay, commissions, etc., are realized when the beneficiary receives a cheque from the deceased's employer.

If the rights or things are not transferred to a beneficiary as described above, the rights or things can be included in a separate return. The separate return includes only the value of the rights or things and assumes that the taxpayer was another person. In other words, income splitting is allowed to the extent of the value of the rights or things because they are not included in the regular terminal return with the deceased's other income. This is beneficial because the marginal tax rate which will apply to the rights or things will normally be lower than the tax rate applicable to the other income in the regular terminal return. Additionally, most personal tax credits may be claimed in the separate return, including the basic personal credit, the married person's credit, the dependent person credit and the age credit, notwithstanding that the full amount of such credits can also be used in the regular terminal return.

Probate Fees

Although it is not a tax in the traditional sense, many professionals refer to probate fees as a tax. There are various methods of planning to lower probate fees, but they can bring their own challenges and potential pitfalls. Common strategies include: holding assets jointly, transferring assets during one's lifetime, multiple wills, and designating beneficiaries. However, it is important that a person's estate plans come first, and probate planning comes second, because these probate planning strategies can potentially upset a person's bequests.