MONTHLY NEWSLETTER

Death of a Taxpayer

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NOVEMBER 2015

Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

In many cases, family members or trusted friends are designated as executors of a will. When an individual taxpayer passes away, the unfamiliar and sometimes complex tax filing and compliance matters can be overwhelming, particularly when dealing with the loss of a loved one. The purpose of this newsletter is to highlight some of the more common personal income tax implications and filing requirements when an individual passes away, as well as some items that each taxpayer should consider when planning their estate.

RETURNS TO BE FILED

In the year of death, a final personal tax return must be filed (T1 Personal Return) to report income from January 1 to the date of death. There are three other optional returns that may be filed; return for rights and things, return for a partner or proprietor, and/or return for income from a testamentary trust. These additional optional returns are quite rare, and most executors choose to report the income on one terminal return.

If the taxpayer passes away between January 1 and October 31, the final tax return will be due at the regular filing deadline, April 30 of the following year (June 15 for self-employed individuals). If the death occurs between November 1 and December 31, the final return is due six months after the date of the death. Taxes are payable April 30, unless the death occurs between November 1 and December 31, at which point the taxes are due 6 six months after the date of death.

DEEMED DISPOSTIONS, INCOME INCLUSIONS AND ROLLOVERS

When a taxpayer passes away, they are deemed to have disposed of all of their assets for proceeds equal to fair market value immediately before the date of death. A “deemed disposition” for tax purposes is a term used when a person is considered to have “disposed of” or “sold” property, even though a sale did not take place. Essentially, the assets will be treated as if they were sold to an arm’s length party for an amount that would be received on the open market. Any appreciation in the assets from the original purchase to date of the deemed disposition would be taxable. For capital property, such as shares, stocks, or real estate, a deemed disposition could result in a taxable capital gain. For a rental property on which capital cost allowance ("CCA") has historically been claimed, this could also result in an income inclusion for recaptured CCA.

One very common income inclusion that often catches executors and family members by surprise is the inclusion of the fair market value of all Registered Retirement Savings Plans ("RRSPs") and Registered Retirement Income Funds ("RRIFs") in income in the final tax return. For example, if a taxpayer had a RRIF with a fair market value of $120,000 on the date of their passing, the full $120,000 would be taxable in the final return. Generally, a taxpayer would have received income tax deductions for their contributions to an RRSP in the year of the contribution, and then included an amount in income for future withdrawals. As the date of death is the last possible day for the taxpayer to withdraw funds, they are deemed to have withdrawn all of the remaining funds immediately before death, resulting in an income inclusion.

While these circumstances may appear dire, there are particular situations where the Canadian Income Tax Act does offer some relief. In the case where there is a surviving spouse that inherits the assets from the deceased, there is an opportunity to defer income taxes. For most assets, there is a tax deferred rollover permitted where the assets pass to the surviving spouse. The income tax is deferred until the surviving spouse dies. While there is some reporting required, the tax effect is generally more favorable. In order to ensure that a rollover to a spouse is possible, appropriate will documentation is necessary. It is also necessary to ensure that beneficiary information on registered investment accounts (RRSPs, RRIFs, etc) appropriately reflect the spouse as the beneficiary, if that is the wish of the deceased. Finally, all assets transferred must transfer to the spouse within 36 months of the date of death.

DEDUCTIONS AND CREDITS IN THE YEAR OF DEATH

Where the taxpayer had non capital losses or net capital losses carried forward from previous taxation years, these losses can be claimed in the year of death against income and taxable capital gains resulting from the deemed disposition, respectively. Subject to some restrictions, net capital losses, which can generally only be claimed against taxable gains, can be claimed against other types of income in the year of death. Depending on the magnitude of the losses, it may be advantageous in some cases to elect out of the automatic rollover to a surviving spouse, as described above, in order to use losses and have an increased cost for tax purposes going forward.

In the year of death, individuals are permitted to claim federal and provincial tax credits, similar to other taxation years. There are also some special rules applicable in the year of death. For example, medical expenses can be claimed for up to 24 months ending in the year of death where such expenses were not claimed in the preceding taxation year.

PLANNING FOR TERMINAL INCOME TAX AND ONGOING ESTATE CONSIDERATIONS

Depending on the value, complexity, and types of assets a taxpayer holds, consideration should be given to funding the terminal tax at the time of the individual's death. For example, if the majority of a taxpayer's assets are comprised of non-liquid assets, such as real estate or private company shares, the terminal tax liability will result, regardless of whether the assets are actually sold or not.

Private company shares represent a complex area of will and estate planning. As noted above, taxpayers are deemed to have disposed of all of their assets for proceeds equal to fair market value immediately before the date of death. Where the fair market value of private company shares is greater than the adjusted cost basis, this would result in a taxable capital gain, reportable on the final tax return. When assets of the private corporation are distributed to the estate, this could result in a taxable dividend for the estate. The result is double taxable. There are multiple options available, each with different benefits and risks. The most appropriate route often depends on the type of corporation, the tax attributes of the corporation, and the intentions of the taxpayer when they pass away. We recommend that taxpayers who own private company shares meet with their lawyer and tax advisor to ensure their intentions are properly documented and that they understand the income tax implications of their wills.

After an individual passes away, their estate may create one or more trusts that require tax planning and compliance considerations. These considerations often compliment the planning related to the filing of the final tax return for personal tax. Please refer to our July 2015 Newsletter *"Estate Planning: Changes to Testamentary Trusts"* for more information regarding estate returns and recent changes.

OTHER TAXES AND ADMINISTRATIVE MATTERS

It is important that executors notify the Canada Revenue Agency, Service Canada, private pension plan administrators, banks and investment advisors, and other financial institutions when an individual taxpayer has passed away. Most organizations will request a copy of the will and death certificate to allow the executor to begin the administration of the estate.

Probate is the process by which a court confirms that a will is valid. The process involves fees. In Ontario the fees depend on the value of the estate. While the fees are separate from the income tax filings of the estate, executors can be surprised by the additional fees. There are ways to mitigate or avoid probate. This type of planning should be considered where estates have a considerable amount of assets.

Canadian citizens and residents generally do not give much thought to United States income or estate taxes. However, Canadians with considerable worldwide estate values that include U.S. assets, such as U.S. based stock portfolios or real estate, should be cognisant that U.S. estate tax may apply on death. There are planning options available to reduce U.S. income and estate tax in these circumstances.

CONCLUSION

Whether you are a taxpayer completing your own estate plan or an executor administering a trust, your legal and financial advisors can be helpful in navigating these complex rules. If you have any questions or concerns, please contact our office for more information.