death and taxes

TAX & ESTATE BULLETIN

Everyone knows life has two certainties: death and taxes. Fewer know the two often coincide.

Canada has no official death, estate or inheritance taxes. However, without proper planning, on death an estate may be faced with large and unexpected tax liabilities. This bulletin describes how registered or non-registered (open) investments in mutual funds might be taxed on the death of the annuitant / unitholder.

The general rule for open (non-registered) accounts

Though special rules apply to RRSPs and RRIFs, a taxpayer is generally deemed to have disposed of all his or her capital property (including stocks, bonds, mutual fund units, real estate, farms, etc.) immediately before death at fair market value. When the proceeds of disposition exceed the property's adjusted cost base (ACB), the result is a capital gain. Two-thirds (67 per cent) of the capital gain is taxable to the deceased and must be reported in the deceased's final tax return – the terminal return. On that return, a capital gains deduction may be claimed against any capital gains arising from qualifying property, such as shares of a small business corporation or farm property.

Spouse as Beneficiary

The most common exception to the deemed disposition rules occurs when the capital property is transferred to a deceased taxpayer's spouse or testamentary spousal trust (spouse trust). A spouse trust is created by a taxpayer's will. It must meet specific criteria, but generally entitles the spouse to receive all the income of the trust during his or her lifetime. When property is transferred to a spouse or spouse trust, the transfer may be done without triggering any immediate capital gains and the associated tax liability.

Example One

Jack and Nancy are husband and wife. Jack holds a non-registered investment in a mutual fund with an original cost of $150,000. At Jack's death on January 15, 2000, the fair market value of his holdings had grown to $250,000. That represents an accrued capital gain of $100,000.

If Jack left his investment in the mutual fund to Nancy (perhaps by naming her as the beneficiary of this property in his will), the investment can simply be transferred into Nancy's name. Nancy will be deemed to have acquired the property at the same ACB of $150,000, thereby deferring tax on the $100,000 accrued capital gain.

If Nancy wasn't the beneficiary of Jack's mutual fund investment, Jack would have been deemed to have disposed of his units for proceeds equal to the fair market value of $250,000. That would have resulted in a capital gain of $100,000 – 67 per cent of it taxable. Depending on Jack's marginal tax rate in the year of death, the estate may have been liable for taxes of up to $34,000.

ACB Transfer to Spouse Not Always Called For

Sometimes it may not be beneficial to transfer all mutual fund units to a spouse or spouse trust at their ACB. It may be preferable to have the deceased's legal representative (for example, the estate executor) elect to trigger a certain amount of capital gains on the terminal return. This would be advantageous in situations where the deceased taxpayer has unused capital loss carryforwards that would otherwise expire on death, or has an exempt capital gains balance (ECGB) that arose as a result of the 1994 capital gains election. These amounts could be used to reduce the tax on the capital gain that would otherwise result from the deemed disposition of the units at death.

EXAMPLE TWO

Continuing from Example One, assume Jack had $35,000 worth of capital loss carryforwards and a $15,000 ECGB. Nancy is the beneficiary of the mutual fund units.

If no election is made to trigger a capital gain, the units are transferred to Nancy's name at an ACB of $150,000. On Nancy's death, assuming the fair market value of the mutual fund investment remains constant at $250,000, Nancy's estate will realize the capital gain of $100,000 and will be liable for taxes of up to $34,000.

On the other hand, if the executor of Jack's estate had elected to report $50,000 of capital gains on Jack's terminal return, this $50,000 can be reduced to zero by applying both the capital loss of $35,000 and the remaining ECGB of $15,000 against the elected gain. Because Nancy is the beneficiary of the mutual fund investment, she will acquire the units with a total ACB of $200,000. On Nancy's death, the resulting capital gain would be only $50,000, attracting taxes of up to $17,000. If Jack's executor elected to trigger the appropriate amount of capital gains, the savings to the final estates of both Jack and Nancy would be up to $17,000.

The general rules for Registered Retirement Savings Plans (RRSPs)

For many Canadians, the largest tax liability their estate will face is the potential tax on RRSPs. The Income Tax Act states that unless certain conditions are met, the deceased's terminal tax return must report as income the fair market value of his or her RRSP on death. Tax will be payable at the deceased annuitant's marginal rate for the year of death unless this income inclusion can be avoided (by using one of the strategies discussed next).

EXAMPLE THREE

Say Jack set up his RRSP with a mutual fund company in 1982, naming his estate as the beneficiary. When Jack passed away on January 15, 2000, the RRSP account had grown to a value of $300,000. Because Jack's estate was named as the beneficiary, the entire value of the RRSP would be included as income in Jack's terminal tax return. Taxes of up to $150,000 would be owing.

SPOUSE AS BENEFICIARY

When an RRSP account is set up, the annuitant may designate a beneficiary of the RRSP. If a spouse is the named beneficiary, the value of the RRSP at death qualifies as a refund of premiums. This refund of premiums is not taxable to the deceased annuitant; rather, it is taxable to the surviving spouse, who could choose to transfer the amount directly to his or her RRSP or RRIF and claim a deduction equal to the amount of the refund of premiums. The amount would continue to grow tax deferred.

EXAMPLE FOUR

Instead of naming his estate as beneficiary of his RRSP, Jack named his wife, Nancy, as the beneficiary. The $300,000 value of the RRSP would then be taxable as a refund of premiums on her 2000 tax return. She could choose to transfer this amount to an RRSP in her name and would receive an RRSP contribution receipt for $300,000, which would be used to offset the income inclusion of the refund of premiums. The net effect of this is to ensure that tax continues to be deferred after Jack's death.

If the beneficiary of the RRSP is a financially dependent child or grandchild, the proceeds of the RRSP still qualify as a refund of premiums. The Income Tax Act considers a child not to be financially dependent on the deceased annuitant if that child's income for the year preceding the annuitant's death was more than about $7,200. This refund of premiums would be taxable in the hands of the child and not the deceased annuitant. The proceeds of the RRSP could be used to purchase an annuity that must end by the time the child reaches the age of 18.

This alternative has the effect of spreading the tax on the RRSP proceeds over several years, allowing the child to take advantage of personal tax credits, as well as graduated marginal tax rates each year until he or she reaches the age of 18.

There is one situation in which RRSP money can be transferred to a child's or grandchild's own RRSP or RRIF. If the financially dependent child or grandchild was dependent on the deceased annuitant by reason of physical or mental infirmity, then the amount that qualifies as a refund of premiums may be rolled over into the child's RRSP or RRIF.

In all other situations, if the children were not financially dependent on the deceased, the entire value of the RRSP would be taxable in the deceased annuitant's terminal return.

EXAMPLE FIVE

Nancy has received Jack's RRSP as a refund of premiums and transferred the $300,000 to an RRSP account in her own name. As outlined in Example Four, this defers the tax otherwise due upon Jack's death. She names her 35-year-old daughter, Judy, as the beneficiary of her RRSP. Judy has a great job and isn't mentally or physically challenged. When Nancy passed away in February 2000, the fair market value of the mutual fund investment had grown to $310,000. The entire amount is taxable on Nancy's 2000 terminal tax return; no further relief, rollovers or planning to postpone the tax liability is possible.

ESTATE AS BENEFICIARY

Sometimes an RRSP annuitant will name his or her estate as the beneficiary of the plan. In this case, where an amount is paid from an RRSP to the estate for the benefit of either the spouse or a financially dependent child or grandchild (assuming they were beneficiaries under the will), the legal representative of the estate, along with the beneficiary, can file an election with the Canada Customs and Revenue Agency, or CCRA (formerly Revenue Canada), to treat the amount as though it was transferred directly to the spouse or child from the RRSP. In this case, the same refund of premiums treatment can be obtained.

EXAMPLE SIX

Nancy is the beneficiary of the entire estate, as specified in Jack's will. Jack has named his estate as the beneficiary of his RRSP. Upon Jack's death, Nancy and the executor of Jack's estate could file a joint election to deem the $300,000 to be a refund of premiums. When transferring this amount to her RRSP, Nancy will receive an offsetting contribution receipt as though she'd received the money directly as a named beneficiary of the RRSP.

Registered Retirement Income Funds (RRIFs)

The rules concerning the taxation of RRIF accounts on death essentially mirror those for RRSPs, with some minor variations. Generally, an annuitant of a RRIF must include in income the fair market value of his or her RRIF on the date of death. This amount must be reported on the terminal return, and tax will be payable at the deceased annuitant's marginal rate for the year of death.

RRIFs share RRSPs' potential for tax deferral on the income inclusion in the terminal return. When a RRIF is established, the annuitant may designate a successor annuitant and/or a beneficiary of the RRIF.

A successor annuitant is the surviving spouse of the original annuitant who, if designated by the annuitant, continues to receive RRIF payments after the death of the original annuitant.

Alternatively, if a spouse is the named beneficiary of the RRIF, the value of the RRIF at death qualifies as a designated benefit. This designated benefit is not taxable to the deceased annuitant; rather, it's taxable to the surviving spouse, who can transfer this amount directly to his or her RRSP or RRIF and can claim a deduction equal to the amount of the designated benefit. By doing so, the value of the RRIF is simply transferred into the surviving spouse's RRSP or RRIF and can continue to grow tax deferred (less the required minimum annual withdrawals).

Example Seven

John, age 67, and Ann, age 72, are husband and wife. Ann has a RRIF from which she is currently receiving payments each year. On February 5, 2000, after Ann withdrew the minimum amount required from the RRIF for 2000, she died.

If Ann had named John as the successor annuitant under the RRIF, beginning in 2001 the RRIF payments would simply continue as before, except they'd be paid to John, not Ann. On the other hand, if Ann had designated John as the beneficiary of her RRIF, the entire fair market value at February 5, 2000, would be taxable to John as a designated benefit. If John didn't need the income, he might choose to transfer the amount into an RRSP instead of a RRIF, maximizing the amount that can remain tax deferred. John is able to do this because he is still under age 69, the age at which an RRSP must be collapsed. He would obtain a contribution receipt for the amount of the transfer; that would offset the income inclusion of the designated benefit. The result would be a tax-free rollover from Ann's RRIF to John's RRSP.

If the beneficiary of the RRIF is a financially dependent child or grandchild, the proceeds of the RRIF still qualify as a designated benefit. This designated benefit is taxable in the hands of the child, not the deceased annuitant. The proceeds of the RRIF could then be used to purchase an annuity that must end by the time that child reaches the age of 18.

If the financially dependent child or grandchild is dependent on the deceased annuitant by reason of physical or mental infirmity, the amount that qualifies as a designated benefit may be rolled over into the child's or grandchild's RRSP or RRIF. If the children are not financially dependent, the entire value of the RRIF will be taxable in the deceased annuitant's terminal return.

Finally, as with RRSPs, if a RRIF annuitant simply names his or her estate as the beneficiary of the plan, the amount paid from the RRIF to the estate for the benefit of either the spouse or the financially dependent child or grandchild can be considered to have been transferred directly to them. The same treatment outlined in Example Six would apply. As with RRSPs, a joint election between the legal representative of the estate and the beneficiary must be filed with the CCRA.

Getting advice

Bear in mind that the situations outlined here are simple summaries of often complex tax scenarios. All cases should be dealt with on an individual basis, and professional legal and tax advice should always be obtained when dealing with estates.

This Tax & Estate Bulletin was prepared with the assistance of

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