Death and taxes

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

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

Non-registered (open) accounts

Though special rules apply to registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs), a taxpayer is generally deemed to have disposed of all his or her capital property (including stocks, bonds, mutual funds, real estate, farm, 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. One-half (50%) of the capital gain is taxable to the deceased and must be reported in the deceased's final tax return, known as 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 or common-law partner 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 common-law partner, or testamentary spousal or common-law partner trust. A testamentary spousal or common-law partner trust is commonly created through a taxpayer’s Will. It must meet specific criteria, but generally entitles the spouse or common-law partner to receive all the income of the trust during his or her lifetime. When property is transferred to a spouse or common-law partner, or testamentary spousal or common-law partner trust, the transfer may be done without triggering any immediate capital gains and the associated tax liability.
Scenario One
Tax deferral to spouse
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, 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 with 50% 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 $22,500.1

ACB transfer to spouse or common-law partner not always called for
Sometimes it may not be beneficial to transfer all mutual fund investments to a spouse or common-law partner, or testamentary spousal or common-law partner 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. These amounts could be used to reduce the tax on the capital gain that would otherwise result from the deemed disposition of the mutual funds at death.

Scenario Two
No tax deferral to spouse
Continuing from scenario one, assume Jack had $50,000 worth of capital loss carryforwards. Nancy is the beneficiary. 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 $22,500.

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 the capital loss of $50,000 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 $11,250. 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 $11,250.

1 Top marginal tax rate used is 45%.
RRSPs

For many Canadians, the largest tax liability their estate will face is the potential tax on RRSPs. The Income Tax Act (Canada) states that, unless certain conditions are met, the deceased’s terminal 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).

Scenario Three

Estate as beneficiary

Jack sets up his RRSP with a mutual fund company in 1982, naming his estate as the beneficiary. When Jack recently passed away, 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 return. Taxes of up to $135,000 would be owing.

Spouse or common-law partner as beneficiary

Note: Invesco Trimark currently cannot accept beneficiary designations on RRSPs and RRIFs when the annuitant is a Quebec resident.

When an RRSP account is set up, the annuitant may designate a beneficiary of the RRSP. If a spouse or common-law partner is the named beneficiary, the value of the registered plan at death qualifies as a refund of premiums. This refund of premiums may not be taxed in the hands of the deceased annuitant; rather, it can be taxed to the surviving spouse or common-law partner, 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.

If the beneficiary of the RRSP is a child or grandchild, the proceeds of the RRSP still qualify as a refund of premiums so long as the child or grandchild is financially dependent on the deceased annuitant. In this case, the refund of premiums could be taxed in the hands of the child or grandchild and not the deceased annuitant. If the child or grandchild is a minor, 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 RRSP proceeds over several years, allowing the child or grandchild 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 or grandchild’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.
Scenario Four

Tax deferral for registered plans

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 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.

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 common-law partner, 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 Revenue Agency (CRA) to treat the amount as though it was transferred directly to the spouse or common-law partner, or child from the RRSP. In this case, the same refund of premiums treatment can be obtained.

Scenario Five

No tax deferral

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 scenario 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, the fair market value of the mutual fund investment had grown to $310,000. The entire amount is taxable on Nancy’s terminal return; no further relief, rollovers or planning to postpone the tax liability is possible.

Scenario Six

Tax deferral election

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.
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 and RRSPs share the 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 or common-law partner of the original annuitant who, if designated by the original annuitant, continues to receive RRIF payments after the death of the original annuitant.

Alternatively, if a spouse or common-law partner 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 or common-law partner, 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 or common-law partner’s RRSP or RRIF and can continue to grow tax-deferred (less the required minimum annual withdrawals).

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, which 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 common-law partner, or the financially dependent child or grandchild can be considered to have been transferred directly to them. The same treatment outlined in scenario six would apply. As with RRSPs, a joint election between the legal representative of the estate and the beneficiary must be filed with the CRA.
Scenario Seven
Tax deferrals for RRIFs

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, after Ann withdrew the minimum amount required from the RRIF for the year, she died.

If Ann had named John as the successor annuitant under the RRIF, 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 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 able to hold an RRSP up to December 31 of the year in which he turns 71, the time at which the RRSP must be collapsed. He would obtain a contribution receipt for the amount of the transfer. This amount 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.

RRSP/RRIF losses after death

As mentioned earlier, the fair market value of RRSP or RRIF investments is generally included in the deceased annuitant’s income in the year of death.

A subsequent increase in investment value is generally included in the income of the RRSP or RRIF beneficiaries upon distribution. Until the 2009 Federal Budget, there was no income tax provision to recognize a decrease in the value of RRSP or RRIF investments occurring after death and before distribution to beneficiaries.

Now, for final distribution from a deceased annuitant’s RRSP or RRIF occurring after 2008, post-death decreases in value may be carried back and deducted against income on the deceased’s terminal return. The amount will generally be calculated as the difference between the year-of-death RRSP/RRIF income inclusion and the total of all amounts paid out of the RRSP or RRIF after the death of the annuitant.
Tax-Free Savings Accounts (TFSAs)

Death and the TFSA beneficiary
Upon death of a TFSA accountholder, the fair market value of the plan as per the date of death is received tax-free to the deceased’s estate. Any payment made to a beneficiary of the TFSA that relates to an increase in value from the date of death is generally taxable to the beneficiary. These amounts will be reported on a T4A tax slip and identified as “other income.” The amount is to be included as income to the beneficiary for the year that it is paid. A beneficiary designation may be made directly on the TFSA or through instruction of the deceased TFSA accountholder’s Will. Note, however, that the ability to name a direct beneficiary on a TFSA will depend on whether provincial laws have been amended to allow for such designations.

Exempt contribution(s)
Assuming that the spouse or common-law partner of a deceased TFSA accountholder directly or indirectly acquires the rights to the TFSA plan as the beneficiary, it is possible for the spouse/common-law partner to transfer the proceeds over to his or her own TFSA and designate this transfer contribution as an “exempt contribution.” An exempt contribution means that the amount transferred will not affect the spouse/common-law partner’s own TFSA contribution room, nor does s/he require the requisite TFSA contribution room. It is important to note that only a spouse or common-law partner can make use of the exempt contribution.

In order to ensure the contribution by the spouse/common-law partner is considered an exempt contribution, the contribution should be made within the “exempt period.” This period continues up to December 31 of the calendar year following the year of death (or any later time that is approved and acceptable by the CRA). Also, the spouse/common-law partner of the deceased TFSA accountholder must file a prescribed CRA form RC240 titled Designating an Exempt Contribution to a Survivor2 Tax-Free Savings Account (TFSA) within 30 days after the day the transfer contribution is made and designate the contribution as an exempt contribution.

It is important to note that the exempt contribution amount is generally limited to the fair market value at date of death and the payment received during the exempt period.

2 Under the Income Tax Act (Canada), the spouse or common-law partner of the TFSA accountholder is also known as the “survivor.”
**Successor TFSA accountholder**
The TFSA accountholder may designate his or her spouse or common-law partner as a successor TFSA accountholder directly on the TFSA. Upon death of the TFSA accountholder, the proceeds of the TFSA plan simply continue to remain in the tax-sheltered vehicle, and the successor TFSA accountholder becomes the new TFSA accountholder. It is important to note that, where the deceased TFSA accountholder was in an excess TFSA contribution position prior to their death, the successor TFSA accountholder is deemed to have made a TFSA contribution for the amount of this excess at the beginning of the month following his or her death.

Note that the CRA has taken the position that where a spouse or common-law partner has been designated as the sole beneficiary of a TFSA, upon death of the TFSA accountholder, s/he will be treated as a successor accountholder.

**Getting advice**
Bear in mind that the situations outlined above 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.