Tax Planning Before and After Death

No one wants to think about death however, taxpayers who organize their affairs may benefit from current and future tax savings. Addressing the tax that will arise by virtue of death is a key aspect of a sound financial plan. Further, the minimization of tax after death is closely linked to planning adopted during a person's lifetime.

This article, in the space available cannot address all the fundamental aspects of tax and estate planning. Therefore, the article will focus on the following key elements:

- Tax consequences at death
- The benefits of a freeze
- Testamentary trust planning

Many of our clients are owners of private companies. The estate planning issues that arise in a private company context are complex and will be the subject of a future article.

Tax Consequences at Death

Tax that arises at death can be somewhat nebulous; it should not be. The taxation year for a deceased extends from January 1 to the date of death. If a person dies before November, then his or her tax return is due on April 30th of the following year (June 15th if the taxpayer or the taxpayer's spouse was carrying on a business in the year of death). When death occurs after October, the terminal return must be filed no later than six months after death. The tax for a deceased will be due on April 30th of the following year, or six months after the date of death for a person that dies after October.

In the year of death, it may be possible to file more than one tax return. The filing of additional tax returns is pursuant to specific provisions of the Income Tax Act and may lower the deceased's tax liability. In completing the tax compliance for a deceased taxpayer we evaluate the opportunity to file additional returns and make appropriate recommendations.

An individual's terminal tax return will include all income received or accrued before death. The value of a person's RRSP or RRIF will be reported as income on the terminal tax return, subject to the exceptions noted below. Further, the deceased person is deemed to have disposed of all their capital property for fair market value immediately before death. The cost of the various properties owned will determine the aggregate capital gain or loss that arises on the properties owned at the time of death. For taxation purposes, ½ of capital gains realized are included in income and subject to tax.

A person that acquires property from the deceased, is deemed to have acquired the property for fair market value. Therefore, a deceased's estate pays tax on the appreciated value of property; future appreciation in value will be taxed in the hands of the estate or the relevant beneficiaries.

An exception to the basic taxation at death regime is that capital property transferred to a spouse or a qualifying spousal trust will be considered to have been disposed of at cost. On this basis tax on underlying gains may be deferred until the surviving spouse dies. Further, the value of a deceased's RRSP or RRIF that is transferred to a spouse or dependent child / grandchild may also not be subject to tax.

We can readily estimate a person's terminal tax liability, i.e. the amount of tax that will arise at the time of death. In the context of a couple, we complete the exercise jointly and assume that the tax may be deferred until the later spouse's death. A person that dies may also be subject to probate fees and such amount should be considered in evaluating the overall tax exposure to the estate. In Ontario, probate fees apply at a rate of .5% for the first $50,000 of estate value subject to probate and 1.5% of the value in excess of $50,000. An estate with a value of $500,000 subject to probate would attract probate fees of $7,000 [($50,000 x .5%) + ($450,000 x 1.5%)].

Having estimated the tax and probate fees, we will want to ensure that an estate will have sufficient liquidity to fund the liability that arises. In some cases, an estate may be left with limited liquid assets and funding the terminal tax liability may be a challenge.

Based on the information available and our analysis we are now in a position to consider strategies that minimize the terminal tax liability. Further, we can identify opportunities to minimize tax after death for the estate and beneficiaries. Invariably we encounter situations where no planning has been implemented. In such circumstances we can often identify that more tax is being paid than would have otherwise been required. We also ascertain that the executor and beneficiaries are faced with complications that could have been avoided.

The Benefits of a Freeze

The objective of a freeze transaction is to limit the value of property held by an individual. By limiting future appreciation in value we can prevent a person's terminal tax liability from increasing over time. The benefits of a freeze may be highlighted by the following example:

- Mrs. Emily Jackson, who is 65, owns 10,000 shares of the Royal Bank of Canada ("RBC").
- The cost of Mrs. Jackson's RBC shares is $350,000 and the current fair market value is $600,000. Mrs. Jackson is optimistic that the shares continue to rise in value.
- Mrs. Jackson has two adult daughters who will eventually inherit the value of her estate. Mrs. Jackson does not have a spouse.

If Mrs. Jackson died today, she would be deemed to have disposed of the RBC shares and the underlying gain would be included on her terminal tax return. Because she does not have a spouse the disposition occurs at fair market value. Based on the value and cost of the RBC shares, the taxable capital gain would be $125,000 [($600,000 - $350,000) x ½]; tax on the gain may be approximately $57,000 [$125,000 x 46%].

Assume that Mrs. Jackson lives for another ten years and in this period the value of the RBC shares doubles. At the time of her death, the shares have a value of $1,200,000 and the taxable capital gain would be $425,000 [($1,200,000 - $350,000) x ½]; tax on such a gain may be as high as $195,000 [$425,000 x 46%]. By virtue of the appreciation in value, Mrs. Jackson's tax liability has increased from $57,000 to $195,000.

An estate freeze can be used to limit Mrs. Jackson's terminal tax liability vis-à-vis the RBC shares. In fact it may be possible to reduce the underlying tax liability. Specifically, Mrs. Jackson may implement the following plan:

- She incorporates a holding company ("EJ Holdings") – the common shares of the holding company will be owned equally by her two daughters.
- She transfers her RBC shares to EJ Holdings. Provided that Mrs. Jackson files a tax election, she is permitted to transfer the RBC shares at cost. This is referred to as a rollover.
- As consideration for transferring the RBC shares to EJ Holdings, Mrs. Jackson may receive a promissory note for $350,000 (the cost of the RBC shares) and preference shares of EJ Holdings that have a value of $250,000 (the value of the RBC shares in excess of the promissory note).

Because the EJ Holdings preference shares have a fixed value, Mrs. Jackson's terminal tax liability will not increase in the future; hence the use of the term "Freeze"). Any increase in value in respect of the RBC shares will increase the value of the EJ Holdings common shares which are owned by Mrs. Jackson's two daughters. A disposition of the RBC shares will be taxable to EJ Holdings and not to Mrs. Jackson personally. Further, the value of Mrs. Jackson's promissory note can be paid to Mrs. Jackson during her lifetime without any tax.

Now the exciting part – EJ Holdings may redeem Mrs. Jackson's preference shares with the effect of reducing her terminal tax liability. For example, on an annual basis EJ Holdings could redeem $35,000 worth of preference shares. The redemption proceeds will be taxed to Mrs. Jackson as a dividend; the amount of tax that she will pay will depend on her other sources of income. Over a ten year period she could adopt such a strategy to fully redeem the $350,000 of preference shares.

By virtue of not owning EJ Holdings preference shares at the time of her death, Mrs. Jackson would not have a terminal tax liability in respect of what had previously been the RBC share value. The underlying gain has been converted to dividends in Mrs. Jackson's hands and taxed over a ten year period. We can readily estimate the benefit or cost of the strategy. Further, specific planning on an annual basis may be adopted to minimize the tax that arises in respect of the dividends.

The above example illustrates the fundamental benefits of an estate freeze. In practice, an estate freeze may embody the transfer of an entire investment portfolio to a holding company. In some circumstances a rental property may be transferred to a corporation. It will generally not be feasible to transfer a personal use property such as a home or cottage to a corporation. Beyond the income tax savings opportunity, the freeze may also provide an opportunity to minimize or avoid probate fees.

In connection with estate planning, we often establish an estate freeze that includes property owned by spouses. For example, if Mrs. Jackson had a spouse, then he may also transfer property to the same holding company. Their wills may also provide that the first spouse to die leaves their shares to the surviving spouse – on this basis the underlying tax on the preference shares would be deferred to the second death.

A freeze can be an integral part of an individual's overall estate plan. Based on proactive planning we can ensure that tax is minimized at the time of death. It is most common for older persons to complete an estate freeze, for example a person might wait until they are in their sixties to complete an estate freeze. We often propose a freeze transaction that is reversible by using a family trust as a shareholder of the holding company. A reversible freeze introduces great flexibility and can mitigate the concerns associated with completing a freeze too early. A future article will look at the many uses and advantages of a family trust.

Testamentary Trust Planning

A couple may organize their wills to provide for the establishment of a spousal trust at the time of the first spouse's death. The essence of testamentary trust planning is that property is directed to a testamentary trust at the time of the first spouse's death instead of directly to the surviving spouse. Provided that the surviving spouse is entitled to all income and no one can encroach on capital during his or her lifetime, then the disposition at the time of the first death occurs at cost.

A testamentary trust is a separate taxpayer and benefits from the graduated tax rates on income in the trust. The surviving spouse may be given authority to manage the property in the trust and to collapse the trust if they so choose. The testamentary trust is deemed to dispose of its property at fair market value at the time of the surviving spouse's death – this equates to the result if the surviving spouse had owned the relevant property directly. However, the provisions of the testamentary trust may provide that the property in the trust is then distributed to new testamentary trusts for the benefit of one or more children. On this basis the testamentary trust opportunity may flow to the next generation.

We often recommend that the terms of the will provide the surviving spouse with the discretion to forgo the testamentary trust. A surviving spouse could decide to receive the property directly if he or she did not want to make use of the testamentary trust opportunity. It should be noted that if a will does not provide for the establishment of a testamentary trust, then the surviving spouse would not have the discretion to establish a testamentary trust.

In an optimal scenario – testamentary trust planning may lead to annual tax savings of approximately $18,000. The optimal scenario arises for a taxpayer that is in the top tax bracket and can earn approximately $135,000 of income separately in a testamentary trust. For a top tax bracket taxpayer with $50,000 of income in a testamentary trust the savings would be approximately $10,000 per year. The tax compliance fees related to a testamentary trust are generally comparable to personal tax preparation fees.

The 2014 federal budget introduced an important measure that will significantly curtail the benefits of testamentary trust planning. The key implication is that a testamentary trust will only have access to the graduated tax rates for a period of 36 months following the death of an individual. Before this new measure, there was no time limitation on the access to graduated tax rates - this will curtail the long-term benefits associated with testamentary trust planning.

This article has discussed some fundamental estate planning considerations. We would be pleased to review your situation to recommend a customized estate plan that minimizes tax and provides you with peace of mind.

For more information about tax planning before and after death contact a professional at Welch LLP or visit us at: www.welchllp.com.

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