

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.

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

¹Top marginal tax rate used is 45%.

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 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.

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 could be owing.

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.

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 out of the ACB transfer to a spouse or common-law partner 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.

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 the date of 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).

Spouse or common-law partner as beneficiary

Note: Invesco 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, RRIF, specified pension plan (SPP), pooled registered pension plan (PRPP) or to an issuer to purchase an eligible annuity and claim a deduction equal to the amount of the refund of premiums. The amount would continue to remain 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, RRIF, SPP, PRPP or to an issuer to purchase an eligible annuity.

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 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.

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.

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.

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. With a successor annuitant designation, the deceased RRIF annuitant would be responsible for reporting RRIF withdrawals received while alive. The successor RRIF annuitant would be responsible for reporting any new RRIF withdrawals received after the date of death.

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, RRIF, SPP, PRPP or to an issuer to purchase an eligible annuity 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, RRIF, SPP, PRPP or to an issuer to purchase an eligible annuity and can continue to remain tax-deferred (less any 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, RRIF, SPP, PRPP, or to an issuer to purchase an eligible annuity. 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.

Rollover to a Registered Disability Savings Plan (RDSP)

Since July 1, 2011, qualified beneficiaries of an RRSP or a RRIF who are a financially dependent child or grandchild that also has a physical or mental impairment can roll over the proceeds to an RDSP tax-free. These rollovers cannot exceed the maximum RDSP contribution room of \$200,000 and will also reduce the room by the amount transferred. Government grants will not be paid into the RDSP on funds rolled over in these scenarios. Please refer to our Tax & Estate bulletin titled *Registered Disability Savings Plan (RDSP)* for more information.

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.

Scenario Eight

Jack also has a TFSA, and named his wife Nancy as 100% beneficiary of the plan. When Jack passes away, Nancy has until the end of the following year (the exempt period) to facilitate an exempt contribution into her own TFSA. Jack's TFSA was valued at \$100,000 at the time of his death. When Nancy completes the transfer of Jack's TFSA funds into her own TFSA, she has 30 days from the date of the transfer to complete the CRA form RC240 designating the amount as an exempt contribution with the CRA. When Nancy completed the transfer, the TFSA grew to \$101,000. The income generated from the date of death (\$1,000) is included as income to Nancy and is taxed in her hands. She will also need the requisite TFSA contribution room to contribute this amount into her own TFSA as the exempt contribution will generally be limited to the date-of-death value, which in this case is \$100,000.

Scenario Nine

Where Jack named Nancy as a successor TFSA accountholder either directly on the TFSA or through his Will, Nancy can essentially take over the plan immediately after Jack's death, and the plan continues with Nancy as the new TFSA accountholder. Any income generated after the date of death would not be taxable to Nancy, as it is in scenario eight, since she will step in as the new TFSA accountholder immediately after Jack's death, and these amounts continue to be tax-sheltered within the TFSA plan itself. This option is similar to the successor annuitant designation available with RRIFs.

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 and that is paid out by the end of the year following the year 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.

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 or 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 or 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 or common-law partner of the deceased TFSA accountholder must file a prescribed CRA form RC240 titled *Designation of an Exempt Contribution Tax-Free Savings Account (TFSA)*² 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 the date of death and the payment received during the exempt period.

² Under the *Income Tax Act* (Canada), an exempt contribution may only be facilitated by the spouse or common-law partner of the deceased TFSA accountholder. 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 his or her 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.

Scenario Ten

Joseph has an RESP for his 15-year-old granddaughter Ella. The total value of the plan equals \$25,000 (\$20,000 in contributions, \$4,000 in government grants and \$1,000 in investment returns). Joseph passes away prior to Ella beginning post-secondary studies. Upon a review of Joseph's Will, it is determined that he left specific instructions for Ella's father Jack to be the successor subscriber of the RESP in the event of Joseph's death. If there were no instructions in the Will and there was nobody willing or able to continue the RESP as a successor subscriber, the plan may have to be collapsed and the RESP assets, after grants are returned to the government, would be distributed to the beneficiaries of the estate. In either scenario, the assets would potentially be subject to probate. However, the naming of a successor subscriber could save the estate an additional \$650 in taxes on the plan growth (AIP withdrawal of \$1,000 less penalty and income tax).³ More importantly, the naming of a successor subscriber ensures that Ella still has educational assistance with her future school expenses when she needs them.

³ AIP penalty tax is 20%, and the top marginal tax rate used is 45%.

Scenario Eleven

If Ella were to pass away and there are no possible replacement beneficiaries, the RESP would need to be collapsed and all grants would be returned to the government. However, provided he has the necessary unused deduction room, Joseph may be able to transfer (subject to conditions) the AIP amount into his spouse's or common-law partner's RRSP without any withholding tax or penalty tax. It may also be important to note that the AIP rollover to an RRSP or RRIF applies only to the original subscriber of the RESP or the spouse or common-law partner of the original subscriber. If you became the subscriber of an RESP due to the death of the original subscriber, the regular withholding and penalty taxes would apply to the AIP.

Registered Education Savings Plans (RESPs)

Death of an RESP subscriber

Upon the death of an RESP subscriber, if an RESP is held jointly, the surviving joint owner would inherit the deceased joint subscriber's rights in the RESP as per the rights of survivorship provision (except in Quebec) and may continue as subscriber of the RESP. Alternatively, if there is no joint subscriber or the subscriber was a resident of Quebec, the transition from the original subscriber to a replacement subscriber would depend on the provisions of the deceased subscriber's Will. If there is no joint subscriber and the deceased subscriber has not named a successor subscriber through his or her Will, it may be possible for the estate trustee (or legal representative of the estate) to approach the courts to name a new subscriber to take over the RESP. In cases where there is sufficient flexibility accorded to the estate trustee through the Will, it may also be possible for the estate trustee to acquire the rights under the RESP and manage the RESP on behalf of the beneficiary.

If no successor subscriber can be named, an RESP would be terminated as a result of the subscriber's death. All contributions would normally be refunded to the estate of the subscriber, and all Canada Education Savings Grants and any other grants or bonds remaining in the account would be refunded to the government. If certain conditions are met, an Accumulated Income Payment (AIP), which is subject to income tax and a penalty tax, may be payable to the estate. All amounts payable to the estate would normally be distributed along with other estate assets to the beneficiaries of the estate according to the deceased's Will. In these instances, the RESP assets would form part of the deceased subscriber's estate and may subsequently be subject to probate.

Death of an RESP beneficiary

In the event that an RESP beneficiary dies, it may be possible to name a sibling as a replacement beneficiary, subject to certain conditions. If the RESP is a family plan, the surviving beneficiaries would be able to use any growth and government grants (excluding the Canada Learning Bond) that were received by the deceased. Where no replacement beneficiary exists or there is no other beneficiary that qualifies to use the deceased's grant and growth, the plan can be terminated, with the grants being returned to the government and contributions refunded to the subscriber. If certain conditions are met, an AIP (which is subject to income tax and a penalty tax) can be paid to the subscriber. Alternatively, provided sufficient RRSP contribution room exists, it may be possible for the original subscriber or his or her spouse or common-law partner to continue the tax-deferred growth of an AIP by transferring it directly into his or her own RRSP. Under this option, provided certain conditions are met, the income and penalty taxes normally associated with an AIP would be waived.

Scenario Twelve

Jake, a 35-year-old RDSP beneficiary is also the holder of his own plan based on his age and the fact that he is contractually competent. For the past 15 years, annual contributions of \$1,500 have been made into the RDSP, resulting in a balance of \$80,000 (\$22,500 contributions + \$52,500 in Canadian Disability Support Grants + \$5,000 in investment income). If Jake were to die, his RDSP must be collapsed and all funds remaining after the required assistance holdback amount would be paid into his estate to be distributed by the provisions of his Will or the laws of intestacy (if there was no Will) of his province. In this scenario, the assistance holdback amount repaid to the government would be \$35,000 (\$3,500 x 10 years), leaving \$45,000 paid to Jake's estate, of which \$22,500 (\$45,000 - \$22,500 in contributions) is taxable on Jake's terminal return. Additionally, the entire \$45,000 may be subject to probate.

RDSPs

Death of an RDSP holder

In general, the holder of an RDSP can be the parent(s) of the beneficiary, a guardian, tutor, public department, or any other qualified individual or body. Additionally, if the beneficiary is over 18 and legally able to enter into a contract, the beneficiary can also be the planholder.

In the event that an RDSP holder who is not the beneficiary dies, the deceased must be removed from the plan as a holder. Where this occurs, the RDSP rules state that a new holder must be named in order for the plan to carry on. The successor holder of the RDSP could be the beneficiary (provided he or she is the age of majority and contractually competent), a surviving parent or qualified relative, the beneficiary's guardian or a public trustee, to name a few. If a qualified person has not been named in the deceased planholder's Will, the assignment of a successor RDSP holder may have to be determined by the applicable courts or the office of the public guardian or trustee.

Death of an RDSP beneficiary

As discussed above, an RDSP can be managed either by a qualified holder or by the beneficiary himself/herself. In either case, where the beneficiary of an RDSP has died, the RDSP must be closed, all amounts remaining in the plan must be paid out to the beneficiary's estate and the plan must be terminated by December 31 following the calendar year in which the beneficiary dies. Any grant or bonds deposited in the plan in the 10 years prior to the beneficiary's death must be returned to the government (this is known as the "assistance holdback amount"). However, any accumulated growth on these amounts need not be repaid. All other grants, bonds and accumulated growth on the plan will be distributed and taxable to the beneficiary's estate. As with RESPs, original contributions will be distributed to the beneficiary's estate tax-free. In these instances, the RDSP assets would also be subject to probate.

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.



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