My Estate *Includes* The CRA

By: Joe the Investor

When dealing with estates, there are 2 main types of taxes/fees that come up. These are the income taxes and probate fees. These are not the same thing, but the two taxes arrive at the same time – upon someone's death. *This article does not deal with the probate fees part of the estate – this should be considered before making any decisions on income tax since income taxes and probate are related.*

Income taxes are broken into 2 time periods upon someone's death – the last taxation year prior to someone's death, and the period after someone's death. The period before someone's death is covered by the final return. The final return is like any other tax return, but there are special rules regarding charitable donations, capital gains, medical expenses and other claims that are slightly different than a regular return since there will be no future opportunities to "settle" the claims or defer income taxes. The purpose of the final return is to settle all taxes owing from someone's lifetime that have not been taken care of yet. As an example, if you purchase shares or a property and have not realized a capital gain yet, the property would be deemed sold at the day of death, and the income taxes would be due. If you deferred taxes through an RRSP and did not withdraw the funds before the day of death, the taxes are due on the day of death for all of the money that was subject to the tax deferral. This is why tax rates on RRSPs can be large if account sizes are large and there are no other factors to consider. Deferral of taxes in non-tax jargon means delay: The delay is in effect until the strategy is unwound at the day of death. If you have carry forward credits like tuition, capital losses, unclaimed donations or medical expenses, these are also settled or utilized at the day of death. There are situations where some of these claims can be dealt with on the estate return. Professional advice should be consulted for an estate with respect to the possible tax returns to make sure that the best scenario is filed.

For the period after death, there is an optional return called the "Return of Rights and Things". These are income sources only that were in the process of getting paid before death but were not paid until after death. Examples of this are dividend income that was declared (owed to the deceased) before the day of death, but was actually paid after the day of death. Other examples are vacation pay earned before death and not yet paid, employment income earned before the day of death but not yet paid, bond interest accrued but not paid, accrued OAS payments, or work in progress for a self-employed person. Only a limited number of things (no pun intended) can be included in this return but this is a possibility.

The estate return or T3 return deals with income that is generated and occurs after death. This would be income or asset value changes between the day of death and the day of distribution. As an example, someone had 100 shares of Bell Canada worth $5,000 at the day of death, these shares would be "deemed sold" as of the day of death according to the tax rules. In actuality, the shares are not sold and would continue to linger in the estate account until they were actually sold by the executor/executrix. If this happened 1 year later as an example, the shares may be worth $6,000 at the actual day of sale. This means there is an additional $1000 capital gain that would occur in the estate return ($6,000 - $5,000) that would be income for the estate. The same thing can occur with real estate, collectibles, or changes in account valuations after the day of death.

The biggest sources of taxes for the final return are monies that have earned income and not paid taxes on the income for many years. The RRSP is a classic example of this, as well as a lump sum pension payout at death. Periodic payouts are taxed annually, so the tax hit will not be as pronounced. RRIF accounts would also fall into the possible high tax take category since they are extensions of the RRSP. Non-registered investments with large unrealized capital gains would also face a large tax bill. Large unrealized capital losses would reverse this effect and be a source of tax savings. Real estate tends to have large capital gains embedded in it due to holding it of for long time periods. The house someone is living in (principle residence) is exempt from taxes on the final return if they have lived there the whole time that they owned the residence. The wrinkle is that some small tax amounts may be owed from the date of death to the date of distribution on the estate return for capital gains accumulated over this period. Investment properties would be subject to capital gains or losses as well.

Does my estate *have to include* the CRA? Likely the answer is yes, but it will vary widely depending on the income situation at the day of death.