# Estate Planning and the Use of Trusts

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# Estate Planning Fundamentals

The estate planning process is always driven firstly by the testator's intentions and manner in which the estate assets are to be dealt with. The estate planning advisor should always bear in mind that these intentions take precedence in the overall estate plan. However, tax planning can and does play a significant role in structuring the overall estate plan.

The planning process will therefore necessarily include an estate succession structure which minimizes the overall tax impact, with a view to preserving the Estate value for the next generation. While there are no Estate or Succession taxes in Canada, and probate costs are not generally significant in Manitoba, personal income taxes are payable on the date of death return (terminal return), and these income taxes can be a significant factor.[1]

Canadian law taxes all income, accrued gains, deferred income (registered plans), and reserves, to the date of death, as the taxpayer is effectively "exiting" the tax system. The concept of requiring the inclusion of all such amounts into income, effectively levies a "succession tax" on the Estate prior to the Estate assets being passed to the next generation. This tax is really "inter-generational," as Canadian tax law virtually provides for a complete rollover of the Estate assets and a deferral of such taxes where the testator's assets are bequeathed and transferred to a surviving spouse or a spouse trust.[2]

There are, of course, many other exemptions, credits and deductions which can provide tax relief.

There are also fundamental tax planning concepts which can be employed to preserve the overall Estate value. Our Canadian tax laws have provided the Estate planner with a number of "tools" which can be employed in connection with the fundamental concepts of tax planning, to achieve a tax-efficient Estate plan.

The fundamental tax planning concepts can be employed on an inter-vivos, testamentary and even a post-mortem planning basis. The three basic pillars of these concepts are:

1. Income-splitting;
2. Deferral of tax; and
3. Use of tax-exemptions and credits

The "tools" of the Estate planner include the use of inter-vivos and testamentary trusts, the use of special elections and "rollovers" provided for in the tax legislation, the use of corporate entities, and the use of life insurance to preserve estate value.

It is also possible for the Estate tax planner to "multiply" the benefits of "income-splitting" or multiply the use of exemptions, by employing such strategies on a multiple basis, where there are multiple beneficiaries.

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[1] Subsection 70(5), deemed disposition of capital property at fair market value immediately before death.
[2] Subsection 70(6), transfer or distribution to spouse or spouse trust.

This paper will examine a number of the basic planning opportunities available to the Estate planner, with a view to adding value to client services and managing engagement risk.

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**1. Income-Splitting**

If you transfer property to your spouse, your common-law partner, or a minor, the "income-attribution" rules will apply.[3] That is, the income from the transferred property is deemed to "attribute" back to you, and will therefore be taxable in your hands.

The income attribution rules apply to income from property and capital gains on property transferred to a spouse/common-law partner. However, only income from property is attributed on a transfer to a minor, and not capital gains earned on the transferred property. The attribution rules do not apply where property is transferred at fair market value and where fair market value consideration is received by the transferor.[4] Fair market value consideration can include a demand loan payable to the transferor, where interest is paid on the loan, at a rate not less than the prescribed rates under the Income Tax Act (Canada).

Consequently, if no capital gains have accrued at the particular time of the estate plan, "estate freezing" and future "income-splitting" can be accomplished very simply by affecting a sale at fair market value in exchange for a demand promissory note bearing interest at the "prescribed rate".[5] Of course, if unrealized capital gains have already accrued, a more complex solution will be required to effect an "estate freeze" with future "income-splitting" in favor of intended beneficiaries.

"Income-splitting" can be implemented on an inter-vivos or testamentary basis. These concepts, with examples, will be examined in greater detail in this paper.

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**2. Deferral of Tax**

Tax deferral involves the concept of reducing the "net present value" of the tax otherwise due on death by delaying the payment of the tax for as long as possible. This can be achieved as follows:

(a) transferring assets on death outright to a surviving spouse; or
(b) transferring assets on death to a spouse trust; and
(c) transferring qualified farm property or shares of a qualified family farm corporation on death to a child on a tax-deferred "rollover basis".

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[3] Subsection 74.1(1), transfers and loans to spouse
Subsection 74.1(2), transfers and loans to minors
[4] Subsection 74.5(1), transfers for fair market consideration
[5] Subsection 74.5(2), Loans for value

Although the death of a taxpayer generally creates a deemed disposition of all of the taxpayer's assets at the time of death, with the result that a capital gains tax may be payable, Canadian tax law provides for a tax deferral and a "non-recognition" of the crystallization of such gains, where the estate assets are transferred indefeasibly to the surviving spouse or to a "spouse trust."[6]

In view of the fact that the transfer on death is involuntary and that the amounts which would otherwise be included in income may be significant, the ability to defer tax on a "spousal rollover" is of considerable value.

A spousal deferral is available with respect to:

- non-depreciable capital property;
- depreciable capital property of a prescribed class;
- land inventory;
- resource properties;
- reserves; and
- registered funds (RRSP's and RRIF's)

The estate plan may also contemplate the use of "testamentary" trusts, particularly where there may not be a considerable gain realized on a deemed disposition on death, but where there is potential for future growth in the transferred property. The transfer of property to one or more testamentary trusts (other than a spouse trust) can accomplish a transfer of the future capital growth of the property, thereby deferring the realization of the future capital gains tax inter-generationally.

However, sometimes a deferral does not produce the most beneficial tax result. Relevant issues to consider include:

(1) If the spouse is to receive income from investments purchased with cash (e.g. From insurance proceeds payable to the Estate), it may be advisable to place the funds into a trust which does not qualify as a spouse trust. In this way, there will be no capital gain on the testator's death and no deemed realization on the spouse's death;

(2) If non-depreciable capital property to be left to the surviving spouse actually carries an unrealized capital loss, it may be desirable to trigger a deemed realization on death so as to reduce other capital gains which may otherwise occur in the terminal year;

(3) Alternatively, if the testator has deductible losses in the terminal year, a deemed realization of capital gains immediately prior to death would be a better strategy than deferring such gains on a transfer to a spouse trust.

Significant tax deferrals can also be achieved by preserving the "tax reserves" inherent on the transfer of certain types of property to the spouse or to the spouse trust. For instance:

- Reserves on the sale of capital property; and

[6] Subsection 70(6), where transfer or distribution to spouse or spouse trust

- Land inventory of the deceased which would (if not rolled to the spouse), become capital property in the hands of the spouse or spouse trust.

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**3. Use of Tax Deductions, Exemptions and Credits**

Deductions, exemptions and credits can be available on the various returns which might be filed for the deceased taxpayer on the terminal return, and successive trust returns.

The goal is to utilize these items to the maximum extent by either accelerating the reporting of deemed realizations if the taxpayer has unutilized losses, or by deferring, splitting or shifting income if deductions might be available to other taxpayers such as a spouse or child.

The main items available to the estate planner include:

**Deductions/Exemptions**
- $500,000 lifetime capital gains deduction
- Net capital losses
- RRSP deduction room

**Credits**
- Personal credits (can be multiplied for each return filed in the year of death)
- Medical expense credit
- Donation credit

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# Inter-Vivos Estate Planning

There are obviously a number of ways in which property can be transferred to achieve a testator's estate planning wishes.

A common conclusion is that a degree of "estate-planning" can be achieved on an "inter-vivos" basis by simply affecting a gift or a transfer of property, or by transferring title of the property to an intended beneficiary.[7] While this may be a direct, simple method, it can trigger many tax problems and other complications.

Typically, the type of asset considered for a "gift" or transfer would include an appreciating asset, such as:

- real estate (a cottage for instance);
- a stock portfolio;
- shares of a family owned business; or
- farm property

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**1. Gifting**

An outright gift of property for no consideration can create a number of problems, notwithstanding the potential for a capital gains tax on the deemed disposition of the property resulting from the "gift".

Future income earned on the transferred property might be attributed back to the transferor, (where the beneficiary is a spouse or a minor child), since inadequate consideration was received on the transfer.

Also, a number of other problems can occur; specifically:

- loss of control over the asset transferred or gifted;
- the loss or availability of elective provisions in the Income Tax Act (Canada), such as s.51, 85, 86;
- the absence of any liquidity of the transferred asset;
- potential valuation issues and a potential concern over Section 69(1) of the ITA; and
- possible application of the superficial loss rules under paragraph 40(2)(g) of the ITA

The "simple act" of transferring title to another person or registering the property in "joint ownership" with another person can trigger these disastrous consequences.

For these reasons, the estate planner should consider other methods of achieving an "inter-vivos" estate freeze, including:

- a sale of the property at fair market value, for fair market value consideration; or

[7] Subsection 69(1)(c)

- utilization of a Section 85(1) holding company "freeze" of the assets in favour of the intended beneficiaries; or
- utilization of Section 86(1) freeze of an existing corporation in favour of the intended beneficiaries.

These strategies will be reviewed in more depth as outlined below:

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**Sale or Gift to an Inter-Vivos Trust**

The control issue to the "freezor" can be addressed by effecting a transfer or sale of the asset to an inter-vivos trust. The taxpayer can then exercise control over how the property is used, either by the selection of trustees and/or by restrictions specified in the trust document.

Care must be taken to ensure that the trust is appropriately structured, so that the income attribution rules of the Act are not triggered, where minor children or a spouse are beneficiaries of the trust.

An inter-vivos trust is, in common terms, a trust which is created by a living person. Under the Income Tax Act (Canada), an inter-vivos trust is defined as a personal trust that does not qualify as a testamentary trust.[8] This means that a trust which is established by virtue of an individual's Will could conceivably be taxed as an inter-vivos trust, if it failed to qualify as a testamentary trust.

For tax purposes, when a settlor transfers property into an "inter-vivos trust", the transfer of these assets will result in a disposition for tax purposes, which could create a tax liability. Generally, there is no "tax-free" rollover into an "inter-vivos trust", excepting certain inter-vivos trusts, which are specifically defined as an "alter-ego trust"[9] or a "joint partner trust".[10]

Consequently, the use of an inter-vivos trust for estate planning purposes is generally only used where the transferred property will not create an immediate tax liability to the settlor.

A second sobering tax implication for the settlor is that income of the trust will be attributed back to that individual, should the settlor retain a reversionary interest or right to the capital of the trust.[11]

Income attribution to the settlor can occur if:

- the property of the trust can revert back to the settlor; or
- the settlor reserves the right to determine later who receives property from the trust; or
- the settled property of the trust can only be disposed of with the consent of the settlor.

[8] Section 108(1)
[9] Alter-ego trust, Section 248(1); see also paragraph 104(4)(a)
[10] Joint partner trust, Section 248(1); see also paragraph 104(4)(a)
[11] Subsection 75(2)

In effect, the use of an "inter-vivos" trust for effective estate and tax planning requires the settlor to give up control of the asset settled into the trust.

However, an "inter-vivos" trust does have its place in an effectively-engineered estate plan. For example, an inter-vivos trust is an excellent vehicle to introduce as a new equity shareholder, in connection with a Section 86(1) reorganization of capital, or a Section 85(1) holding company freeze.

A trust can also be used as a "stand-alone" vehicle to establish a freeze for family assets such as a cottage property. Many cottages purchased thirty or forty years ago now have market values in excess of $500,000. The accrued gain on the family cottage can result in capital gain taxes on the "last-to-die" scenario. At that time, the ability to access the principal residence exemption may either not be available or could be diminished significantly, depending on other real estate properties owned by the testator. The use of an inter-vivos trust to deal with this type of issue can create a "certainty" to the estate plan.

For these reasons, it is not uncommon to consider gifting or "selling" the cottage property to an inter-vivos trust, thereby shifting the future appreciation to children or grandchildren.

In many cases, the immediate capital gain realized on a "gift" or "sale" can be managed. Very often, the significant increase in the cottage value has occurred because of capital repairs, renovations or additions to the property. These costs should be tracked and added to the "adjusted cost base" for tax purposes, to determine the true capital gain reportable on a disposition.

Alternatively, the settlor (generally the parent or grandparent) may have access to their principal residence exemption and may be able to gift or sell the cottage property to an inter-vivos trust without triggering any capital gains tax.

The inter-vivos trust would acquire the transferred property with an adjusted cost base equal to the fair market value of the cottage property at the time the trust is settled. In effect, the gift or transfer to the trust creates a "step-up" in the adjusted cost base (ACB) of the property for tax purposes.

The trust can continue to hold this property for the benefit, use and enjoyment of all beneficiaries. However, because all and any future capital gains earned on the property from the date the trust is created or "settled", to its twenty-first anniversary will, on the twenty-first anniversary date for the trust, be subject to capital gains tax, ownership of the trust property (the cottage) would generally be transferred on a "tax-deferred" rollout basis to the beneficiaries immediately prior to such date.[12]

This strategy effectively defers the capital gains tax on the cottage until the eventual owners (or their spouses) pass away. It is therefore an effective tool to achieve a significant degree of tax deferral.

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[12] Subsection 107(2)

**3. Holding Company Freeze**

By incorporating and transferring growth assets to a holding company, it is possible to:

- Freeze the asset values;
- Avoid income attribution;
- Defer taxation;
- Maintain control; and
- Transfer future appreciation to the next generation.

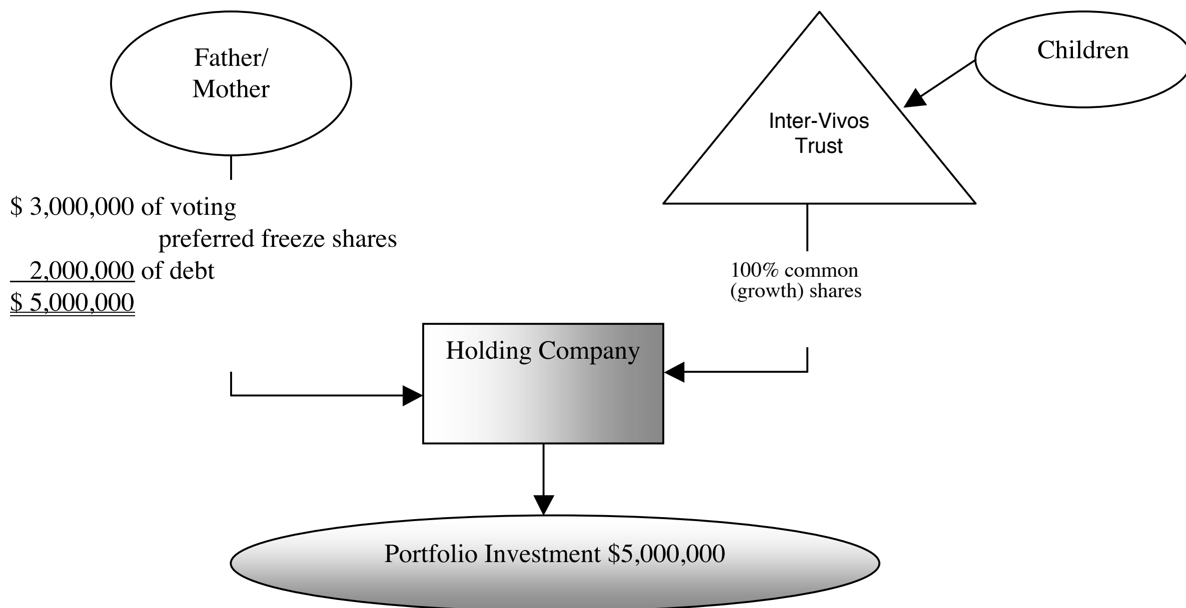
If an appropriately prepared election is filed with the Canada Revenue Agency ("CRA"), the realization of capital gains can be deferred on a transfer to a corporation.[13]

Consider the following example:

Father holds a portfolio of marketable securities with potential future appreciation. The cost is $2,000,000 and the fair market value, $5,000,000.

An estate freeze in favour of a holding company could be implemented, with the common shares of the holding company owned by an inter-vivos family trust. Consideration issued by the holding company would include voting preferred "freeze" shares issued to the father, thereby ensuring that he retains voting control over the corporation.

Care should be taken to ensure that a benefit is not deemed conferred on the trust or the children.[14] For this reason, it is imperative that proper valuations are used.




The benefits of this structure include:

- Effective freeze of taxpayer's assets at $5,000,000
- Deferral of capital gains;
- Effective transfer of growth in the portfolio to the inter-vivos trust for the benefit of the children; and
- Ability to manage income attribution issues.

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[13] Prescribed form – T2057

[14] Subsection 85(1)(e.2)

**4. Estate Freeze**

In general, where a taxpayer owns all of the common shares in a corporation, a freeze can normally be undertaken by implementing a reorganization under Section 86 of the ITA, in the course of which all of the transferor's shares would be exchanged for, or converted into, special preference shares. New common shares would be issued to new shareholders (typically the taxpayer's children or perhaps an inter-vivos trust for the benefit of the children), as chosen by the taxpayer.

To affect this type of freeze, a separate holding company is not required. The existing share capital of the company is "reorganized" (under the particular legislation in which the company was incorporated) with the freezor exchanging the common growth shares for "fixed-value" preference shares having a fair market value equivalent to the "old" common shares immediately prior to the time of the exchange.

A growth asset is therefore exchanged for an asset with the same value, but with no potential for future growth. The freezor's children (successors) would then subscribe for new common growth shares in the corporation at nominal value. The future growth is, in effect, transferred to the new common shareholders, with all increases in the value of the corporation belonging to the common shareholders.

Section 86 is applicable only where the taxpayer's shares are disposed of "in the course of a reorganization of the capital of a corporation". The taxpayer is deemed to have disposed of the "old" common shares for proceeds equal to their adjusted cost base, and to have acquired the "new" shares at an adjusted cost base equal to the adjusted cost base of the old shares. Accordingly, Section 86(1) can provide for a complete rollover and deferral of the capital gains tax to the freezor, while accomplishing the following:

- Shifting the future capital gains tax;
- Deferral of tax to the next generation; and
- Future "income-splitting" potential

However, adverse tax consequences can arise if inappropriate valuations are used in connection with the freeze. Subsection 86(2) provides that a benefit can reasonably be considered to have been conferred on persons related to the taxpayer as a result of the reorganization, if the fair market value of the "old" shares held by the freezor, exceeds the fair market value of the share consideration received on the exchange. If the "gift portion" exceeds the adjusted cost base of the exchanged shares, subsection 86(2) will result in a capital gain being triggered.

In order to avoid recognition of a capital gain as a result of the Section 86 Reorganization, it is critical that the freezor receive a "fair market value" for the new preference shares, which is equivalent to the fair market value of the "old" common shares so exchanged.

In order to ensure that the freezor receives "freeze" shares with adequate fair market value, it is advisable that the preference shares be:

- redeemable at a value equivalent to the value of the "old" common shares;
- retractable at the option of the holder;
- entitled, at least, to restricted dividend rights;
- voting; and
- entitled to certain rights related to the winding-up of the corporation.

These provisions are detailed more precisely in Advance Tax Ruling ATR-22R "Estate Freeze Using Share Exchange".

Although a Section 86 Reorganization is usually a very good approach to implement an inter-vivos estate freeze, there are circumstances where such a strategy may not be appropriate.

For instance, where there are two individual beneficiaries who have dramatically different income needs or where they are not on good terms, it would not make sense to introduce them both into a "joint ownership" situation in a corporation with non-liquid assets.

In such circumstances, it might be possible to separate the business or property assets into two separate corporations first, in which only one person holds an equity interest in each corporation. This type of re-structuring is typically referred to as a "butterfly reorganization", and is much more easily accomplished prior to an "estate freeze" due to the very complex and restrictive requirements of such a reorganization.

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**5. Alter-Ego and Joint Partner Trusts**

These relatively new types of trusts have been created under statute[15] to permit the transfer of assets into a trust without triggering a disposition of the property at the time of the transfer. In effect, property which is transferred into these types of trusts is "rolled-in" at the adjusted cost base to the transferor, and the trust assumes the identical cost for tax purposes.

Also, these trusts are not subject to the twenty-one year deemed disposition rule which applies to an inter-vivos trust.

However, only individuals who are over the age of sixty-five are eligible to contribute to such trusts. Their usefulness in tax and estate planning is therefore somewhat limited, as there really is no tax deferral or income-splitting tax savings achieved.

On the death of the settlor (alter ego trust) or the last-to-die (joint partner trust), the trust is deemed to dispose of its assets at fair market value, and capital gains tax is exigible in the same manner as would have occurred on a last-to-die basis, without the use of the trust.

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[15] Section 248(1)

The main reasons for establishing such a trust would be to affect an avoidance of probate fees in the jurisdiction of the testator or to take advantage of differing provincial income tax rates by "jurisdiction shopping".

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# Testamentary Estate Planning

**1. Overview**

Estate and tax planning at the testamentary level is usually focused around the client's intention to affect a transfer of wealth to a surviving spouse, a child or grandchild, or a charity, while of course, minimizing the estate tax implications.

The fundamental concepts and tools of estate planning which apply on an inter-vivos level, apply equally on a testamentary basis. The estate planner should always attempt to construct an estate plan to achieve a degree of tax deferral, the potential for income-splitting and the utilization of available deductions, exemptions and tax credits.

Of course, some of the "tools" which can be employed on a testamentary basis will differ from those which are available for inter-vivos estate planning.

This next section examines some of the planning options available to the estate tax practitioner.

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**2. Direct Bequest by Will**

An outright transfer to a surviving spouse will defer the immediate realization of capital gains and other amounts which would otherwise become taxable as a result of the deemed disposition rules on death.

However, there are other factors to consider other than achieving an immediate tax deferral. For instance:

- the tax-deferral may be "short-lived"; or
- there may be a concern for the loss of control over the ultimate disposition or use of the assets. The surviving spouse would assume all the rights and benefits of ownership and could deal with the property as they deem appropriate. This issue can be a concern where the testator has an implicit wish to ultimately benefit his children, whether or not the surviving spouse is a first or second partner; or
- there could be a concern over credit risk or exposure to third persons; or
- the tax consequences attaching to the property on a last-to-die basis may be so significant that it may adversely affect the testator's ultimate intention to benefit his children; or
- there may be beneficiaries other than the spouse, which the testator wishes to benefit and to continue to provide for, after a last-to-die occurrence.

For these and other reasons, the estate tax practitioner would look to other tools, including the use of trusts created under the direction of the Will, called "testamentary trusts".

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### 3. Testamentary Trusts

A testamentary trust is a trust which arises as a result of the death of an individual.[16] By definition, assets contributed to the trust occur solely by virtue of the death of the settlor, and no assets can be contributed before the occurrence of such death, nor can assets be contributed to the trust by any other person.

Normally, a testamentary trust is established under the terms of a Last Will and Testament; however, a testamentary trust can also be established by a trust declaration or by agreement.

A trust established by another "testamentary instrument", such as a life insurance beneficiary declaration, or a registered investment beneficiary designation, can also qualify and be constituted as a testamentary trust.

A testamentary trust is an ideal "tool" for estate planning purposes for a variety of reasons:

- It is taxed at graduated rates;
- The trust can have a year-end other than December 31, which can permit for a considerable degree of planning;
- The ability to designate income as being taxable to the trust, notwithstanding payment made to the beneficiaries; and
- The provisions of income attribution do not apply to testamentary trusts in respect of property income paid to beneficiaries under the age of 18 years; and
- There is obviously no "attribution" issues, as the settlor of the trust is deceased.

Estate planning through the Will can be further enhanced by providing for the creation of "multiple testamentary trusts"; that is a separate testamentary trust created for each intended beneficiary. This strategy can achieve a significant degree of income-splitting by multiplying the benefits of the graduated tax rate regime in respect of each and every beneficiary, whether an adult or a minor.

This strategy can significantly expand the low tax base accessible to the family. However, there are limitations to the use of "multiple trusts". The tax legislation is designed to tax "multiple trusts" in common, as a single trust, if the trusts have a common settlor and a common beneficiary or beneficiaries.[17]

A testamentary trust can lose its status as a testamentary trust under certain conditions, namely:

- Inter-vivos contributions.
  Property received by a testamentary trust from an outside source other than a deceased individual will generally disqualify the trust from "testamentary status". For example if a beneficiary contributes, borrows or adds funds to a testamentary trust, any such money settled into the trust will disqualify it from "testamentary trust status"; income earned by

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[16] Section 108(1)
[17] Subsection 104(2)

a "testamentary trust" on the estate capital, however, will not disqualify the "testamentary trust status".

- Payment of capital expenses by a beneficiary.
  The payment of capital expenses on behalf of a testamentary trust will, in the same fashion, be considered a "contribution" that would disqualify the trust from its qualifying "testamentary status".
- Failure to distribute assets.
  If the terms of the trust require a distribution of capital to beneficiaries and the trustees fail to do so, this action or inaction can disqualify the trust. If the Will does not expressly provide that the estate assets be continued to be held in a trust, the trustees have an obligation to facilitate the distribution of the estate capital as soon as they are able to do so. This situation is obviously dependent on the facts for the estate.

The types of testamentary trusts which will be reviewed in this paper are:

- The qualified spouse trust; and
- The tainted spouse trust.

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**4. The "Qualified Spouse Trust"**

As discussed earlier, the key advantage in establishing a "qualified spouse trust" is to achieve a complete rollover and deferral of tax on death, where the deceased is survived by a spouse or common-law partner.[18]

However, even where the benefits of this tax deferral are attractive, they should be weighed against the needs of other family members and their relative personal tax brackets. For instance, if the income generated within the spouse trust is in excess of the spouse's needs, the benefit of the immediate tax deferral may be outweighed by higher rates of tax on income which the spouse would receive in subsequent years.

To qualify as a "spouse trust" all of the following requirements must be met:

(a) A spousal trust must be created by the testator's Will. It cannot be created as a freestanding document outside of the Will.
(b) The spouse or common-law partner must be entitled to all of the income from the trust during his or her lifetime; and
(c) No person other than the spouse or common-law partner can have any entitlement to the capital of the trust, during their remaining life; and
(d) The assets bequeathed must "vest indefeasibly" in the trust, within thirty-six months of death. The Act does not specifically define the term "vested indefeasibly". However, CRA has published commentary on their interpretation of "vested indefeasibly", for purposes of a "qualified spouse trust"[19] and

[18] Subsection 70(6)
[19] IT – 449R, Meaning of "vested indefeasibly"

(e) The testator must be a resident of Canada, immediately prior to death and the trust created by the Will must have Canadian resident trustees.

There are tax deferral and income-splitting opportunities which can be utilized with a "qualified spouse trust". Generally, the advantages of utilizing a "qualified spouse trust" are as follows:

(1) As mentioned earlier, a transfer to a "qualified spouse trust" can achieve a complete rollover and deferral of tax on the death of the first spouse.
(2) A spouse trust is taxed as a separate individual. Income earned in a "qualified spouse trust" is taxed at the progressive rates, in the same manner as individuals are taxed on their personal returns. This permits the surviving spouse to continue to "income-split" investment income in the same manner as would have occurred prior to the death of the first spouse.
(3) Capital bequeathed on the death of the first spouse can be targeted to the residual beneficiaries (usually the children or grandchildren). This is also a strategy for preserving the estate capital, since the ability to encroach on capital would have to be approved by the trustees of the spouse trust.
(4) A spouse trust can be very useful in a potential second marriage situation. If the testator wishes to ensure that a portion of his wealth is transferred to his children from a first relationship, the creation of a "qualified spouse trust" provides a mechanism to eventually transfer this residual wealth, while still achieving an immediate tax deferral on a deemed disposition at death.

Also, aside from the tax deferral, the testator may not wish to transfer wealth to his children immediately; the "qualified spouse trust" mechanism can serve both objectives.

When drafting a spouse trust, consideration should always be given to provide powers to the Trustees to encroach on capital for the benefit of the spouse. For instance, capital property distributed to the spouse pursuant to the provisions of subsection 107(2) can be "rolled-out" at cost. The ability to do so can provide an opportunity to split future capital gains between the trust and the spouse, in respect of property originally settled on the trust.

Of course, such powers of encroachment also provide the Trustees with the ability and flexibility to meet emergency cash needs of the surviving spouse.

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**5. The "Tainted Spouse Trust"**

If a trust does not meet the test of a "qualified spouse trust", it may be a "tainted spouse trust". The term itself is not specifically defined in the Act. For instance if a trust created under the Will provides for an income or capital interest to a beneficiary, in addition to the spouse, the "spouse trust" becomes tainted.

There are means of "untainting" the trust. For instance, if the other beneficiary were to disclaim or "renounce" this interest and give up any claim to income or capital from the trust, the "tainted spouse trust" can be remedied.

There are also specific remedies set out in the Act which provide for the trust to make payment of certain expenses outside of the normally permitted expenses of a "qualified spouse trust".

The most serious consequence of inadvertently creating a "tainted spouse trust" is that a capital gains tax will be triggered on death which might otherwise have been deferred had a properly constructed "qualifying spouse trust" been created.

Sometimes, however, a "qualified spouse trust" may not be entirely satisfactory or necessary and the estate plan might call for a strategy to deliberately "taint" the spouse trust. Property which might otherwise be transferred to a "qualified spouse trust" would not be exempted from a deemed realization on the spouse's death. Some discretion may be required to determine which properties should go to a "qualified spouse trust" and which properties might be better transferred to another "testamentary trust" such as a "tainted spouse trust". It is not uncommon for a Will to also provide for the creation of a "tainted spouse trust", and to give the executor or personal representative broad powers to determine which properties are best suited for each trust.

In such cases, very careful consideration must be given to the methods by which this might be achieved. One way this might be achieved is by creating a provision which would divest the interest of the spouse to encroach on the capital of the trust in the event of re-marriage, or to insert a provision which would permit other persons to benefit from the capital of the trust. Other methods might include a direction to the trustees to pay only a specified portion of the trust income to the surviving spouse.

The creation of a "tainted spouse trust", (effectively just another testamentary trust), would permit a rollout of the property at cost on the death of the spouse, thereby providing a further tax deferral.

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# Post-Mortem Estate Planning

**1. Overview**

The general objective in post-mortem planning for an estate, is to achieve the same benefits and tax savings as might be achieved on an inter-vivos basis. That is, the intention is to achieve a degree of income-splitting, tax-deferral and to utilize available deductions, exemptions and credits.

Where there is discretion under the Will to allocate property in satisfaction of bequests to different beneficiaries, the manner in which such bequests are made can greatly affect the tax consequences for the terminal year.

The existence of broad powers and discretion in the Will, together with the ability to create one or more testamentary trusts, can provide tremendous opportunities for minimizing the income taxes payable in the terminal year, as well as creating long term tax planning advantages for the beneficiaries. Various elections, deductions, exemptions, credits and elections can also enhance the overall estate and tax planning result.

The main options available with respect to planning and filing for the terminal year return, include the following:

- Income-splitting/separate returns
- Tax deferral/rollovers
- Deductions, exemptions and credits

This paper is not intended to exhaustively explore all possible post-mortem planning opportunities. It does, however, focus on the key issues and the more commonly used provisions.

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**2. Separate Returns – "Income-Splitting"**

There are various provisions in the Act which permit the filing of "separate returns" for a deceased taxpayer. There are actually four separate returns which might be filed.

(a) Terminal Return
The first return is the ordinary return covering the deceased taxpayer's income for the period from January 1st of the year of death to the date of death,[20] called the "terminal return". This return must always be filed.

(b) Business Income of a Proprietorship or Partnership
The second is a separate return where the taxpayer operated a business as a proprietorship, or was a member of a partnership. This is described as follows:

[20] Subsection 70(1)

An election to file a separate return is available where death occurred after the close of the fiscal year of the business, but before the end of the calendar year in which the next fiscal year ended.

Unincorporated business income of a deceased taxpayer who reports on a calendar year basis, can therefore be reported on a separate return. The amount reported is the applicable "stub period" income ending to the date of death of the taxpayer.[21]

Where the taxpayer operated on a "non-calendar" year "alternative-method" basis, and died in the year after the close of the normal fiscal year end of the business, a separate return can be filed for the second fiscal period which ended to the date of death.

For 1996 and subsequent years, the deceased individual's December 31, 1995 reserve amount[22] can be reported on a Subsection 150(4) Return of the taxpayer. Where this election is made, a prescribed addition to income under the "alternative method" must be added to the income filed in the terminal return; however, that amount would be deducted on the second separate return. The overall result is that the terminal return reflects both a deduction for the prior year's "additional income", and an addition which is then deducted in the separate return.

Where the death of a partner causes the fiscal year of the partnership to end (terminate), the profits attributable to the deceased partner for the "stub year" can be reported as income on a separate return. However, where the death of a partner does not result in a fiscal year end of the partnership, the "stub-period" income of the deceased partner is considered to be "rights or things", and available for treatment as discussed below.

(c) Income Rights to a Testamentary Trust
A third separate return can be filed where a deceased taxpayer was an income beneficiary of a testamentary trust with a non-calendar taxation year. A separate return can be filed to report only that income arising from the trust after the end of its taxation year up to and including the date of death of the taxpayer.[23]

(d) "Rights or Things"
A fourth separate return can be filed in respect of the value of "rights or things" owed to the taxpayer at the time of death.

"Rights or Things" are considered to be items, which if they had been sold or otherwise realized during their lifetime, would have been included in computing income for the year. The value of such amounts are considered to be "rights or things", and are afforded special treatment in the year of death.

"Rights or Things" can include:

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[21] Subsection 150(4)
[22] Subsection 34.2(8)
[23] Paragraph 104(23)(d)

- dividends declared but unpaid as of the date of death;
- unpaid salaries, commissions and vacation pay owing and unpaid;
- a right to partnership income (see earlier commentary);
- accounts receivable for a cash-basis taxpayer;
- inventories of a cash-basis taxpayer; and
- work-in-progress of a self-employed professional (who would have excluded WIP for tax reporting purposes)

There are three options in dealing with these types of property:

(a) The "value" of the "rights or things" can be included as income in the terminal return of the deceased;[24] or
(b) An election can be made to transfer the "rights or things" to one or more beneficiaries within one year of death,[25] or within ninety days after assessment of the deceased person's terminal return (whichever is the later date). The transferred amount would then be excluded from the income reportable in the terminal return, and instead, subject to tax in the return of the beneficiary for that year; or
(c) A special election can be made to report the value of such "rights or things" as income on a separate return. (See also subsection 70(2))

It is only the "value" of the "rights or things" which must be included in income. Therefore if receivables are uncollectible, or if there is little or no value to inventory or work-in-progress, such amounts would not constitute a "value" to be included in income.

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**3. Rollovers – "Tax Deferral"**

A good deal of post-mortem estate planning centers around the deferral of tax. There are numerous provisions in the Act which provide for a "rollover" on death, with a commensurate deferral of tax. This paper will only highlight the most common rollovers which are generally utilized.

Rollover provisions automatically apply where there is a transfer of capital property on death to a surviving spouse or to a qualifying spouse trust.[26]

(a) Registered Funds

The tax rules relating to the treatment of RRSP's on death depends on whether the plan is matured or unmatured. Detailed information is contained in IT – 500R and Information Sheet RC4177 – Death of an RRSP annuitant.

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[24] Subsection 70(2)
[25] Subsection 70(3)
[26] Subsection 70(6)

Generally, on death, the fair market value of the RRSP (matured or unmatured) is deemed to be received as income by the deceased, immediately prior to death.[27] Similar rules apply for a Registered Retirement Income Fund (RRIF).[28]

There are exceptions of course where there is a surviving spouse or where there are financially dependent children or grandchildren.

In effect, the Act provides "rollover treatment" to such beneficiaries. Otherwise, amounts received as a "Refund of Premiums" or amounts received as a consequence of the termination of a matured plan or RRIF will be subject to tax in the terminal return of the deceased.

(b) Reserves

Generally, the full value of reserves must be included in the income of the deceased on the terminal return. There are, however, exceptions where the property which gives rise to the "reserve" is transferred to a surviving spouse or a spouse trust. The following conditions must be present for the "rollover" of the reserve to be effective:

(i) The deceased taxpayer must have been a Canadian resident immediately prior to death;
(ii) The property relating to the "reserve" must be transferred to the spouse or spouse trust, and the property must vest indefeasibly with the spouse or spouse trust; and
(iii) A joint election must be filed between the estate and the spouse or spouse trust in prescribed form (T2069).[29]

An example of how post-mortem planning might apply with respect to "reserves" can be illustrated with the following example.

Assume that the deceased had sold property to a child in return for a promissory note repayable over a number of years. If, in the deceased's Will, the promissory note is bequeathed to the child, any resulting capital gain previously deferred, would be realized in the terminal return.

If however, the note is bequeathed to a surviving spouse or to a spouse trust, any reserves claimed by the deceased can continue to be claimed in succeeding years, provided that the joint election under subsection 72(2) is filed.

(c) Avoiding the Rollover Provisions

A "rollover" may not always be desirable from an estate planning perspective.

Since unused allowable capital losses of the deceased cannot be carried over and used by the estate or a surviving spouse, triggering accrued capital gains is a way to use up such losses.

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[27] Subsection 146(8)
[28] Subsection 146.3(6)
[29] Subsection 72(2)

Alternatively, the deceased may be disposing of shares of a qualifying small business corporation (QSBC) to a surviving spouse, and may not have fully utilized the $500,000 lifetime capital gains exemption. Obviously, triggering a capital gain on the shares would be desirable, so that the cost base of the shares can be “stepped-up” on the transfer.

To avoid the “rollover” rules from applying on a transfer to a spouse or a spouse trust, a joint election can be made under subsection 70(6.2). The effect of this election is that the particular property will be transferred at fair market value and the spouse or spouse trust will be deemed to have acquired the particular property at fair market value.

Note that the subsection 70(6.2) election is an “off/on switch” and does not provide the parties with an ability to designate an amount between cost and fair market value. Where there are identical properties being transferred (such as shares), it may be possible to designate on some of the property to achieve a desired effect to both parties. Where the subject property is not “divisible”, the requirement under subsection 70(6.2) should be reviewed to ensure that a full election at fair market value creates the desired result for tax purposes.

There is also a provision to opt-out of the principal residence rollover, where the ability to do so is advantageous to the parties.[30]

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**4. Deductions, Exemptions and Credits**

Deductions, exemptions and credits can be available on the various returns which might be filed with respect to a deceased taxpayer.

To the extent that there are unused deductions for the terminal year, it will be desirable to take advantage of various designations to realize income in the terminal return, against which the deductions can be claimed.

Some items which should be considered in formulating the overall approach to post-mortem filing include:

(i) Loss carry forwards in the terminal year return[31]
(ii) Use of the $500,000 capital gains exemption for shares of a qualifying small business corporation or qualified farm property[32]
(iii) Medical expense tax credit (any 24 month period including the day of death)[33]
(iv) Charitable donation credit[34]

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[30] Subsections 70(6.2) and 54(2)
[31] Subsection 111(1.2)
[32] Subsections 110.6(1) and 110.6(2.1)
[33] Subsection 118.2(1)
[34] Subsection 118.1(5)

**5. Capital Gains and Losses**

The legal representative has a number of tools to tax plan for capital gains and losses, on a post-mortem estate planning basis. For instance, the legal representative has an opportunity, in the first taxation year of the estate, wherein capital losses have been realized within the estate in the first taxation year, to carry back and attribute the losses to capital gains reported in the terminal return.[35]

This strategy can be very effective where the estate has acquired capital property, which is declining in value after the testator's death. For instance, marketable securities owned by the deceased at the date of death may have given rise to a capital gain reported in the terminal return. However, if the securities have declined in value thereafter, the legal representative could decide to dispose of the investments and create a net capital loss in the estate. The estate's net allowable capital losses can be carried back and applied against the capital gain reported on the terminal return.[36]

Care should be taken to ensure that such capital losses are triggered within the first taxation year of the estate, otherwise the election under subsection 164(6) will not be available. While this strategy works effectively for this type of capital property, the use of a subsection 164(6) election may not be the best choice with respect to a strategy which involves the redemption of shares of a privately-owned corporation.

This is so because the top effective tax rate of reporting a capital gain in Manitoba is only around 23%, whereas the top tax rate on a "deemed dividend" which results from a "redemption strategy" is around 35%. In this scenario, there is less tax paid on a capital gain resulting from a deemed disposition on death, as opposed to a "redeem" and capital loss strategy, using the provisions of subsection 164(6).

There are, of course, exceptions. Where there is tax-free surplus to distribute using a "share redemption strategy" (such as a dividend paid out of the corporation's capital dividend account[37]) or where there is refundable dividend tax on hand[38] in the corporation, a redemption strategy and a subsection 164(6) election may be a worthwhile strategy.

The legal representative should be aware, however, of various "tax traps" and "pitfalls" which might be encountered by virtue of the affiliated "stop-loss" rules[39] and the capital dividend stop-loss rules,[40] contained within the provisions of the Act.

The other big concern in planning to use capital losses, is that there is no provision to allocate allowable capital losses to a beneficiary. Consequently, with poor planning, there is the potential for capital losses to be wasted!

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[35] Subsection 164(6)
[36] Subsection 164(6)
[37] Subsection 83(2)
[38] Subsection 129(3)
[39] Subsection 40(3.6)
[40] Subsection 112(3.2)

For instance, capital property which is transferred to a "qualified spouse trust" will ultimately be disposed of at fair market value. If the property diminishes in value, the resulting capital loss will accrue to the trust and may not be able to be utilized. If instead, on the death of the testator, the property is transferred to a "tainted spouse trust", the rollout occurs at the adjusted cost base of the property and, on a subsequent disposition of the property, a resulting capital loss may be able to be utilized by the beneficiary.

The legal representative should also be aware of the provisions of subsection 104(13.2), which permit the trustee to make a designation which deems capital gains otherwise includable in a beneficiary's income under subsection 104(21), not to be payable, and instead, included as income (or as taxable capital gains) of the trust.

The effect of this designation is that subsection 104(13.2) permits the trustee to deduct under subsection 104(6), less than the full amount of the taxable capital gains, otherwise payable to the beneficiary. The "undeducted" capital gain can therefore be included in the trust's income for the year and, as a result, creates an amount by which capital losses of the trust realized in prior years, might be utilized.

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**6. Will Gifts**

Where the Will provides for a bequest to charity, care should be taken to determine whether cash, or a "gift-in-kind" instead, might provide the more tax-advantageous route. Generally, where an individual makes a gift to a registered charity by virtue of the Will, the gift is deemed to have been made by the individual immediately before the individual's death.[41]

If the deceased had capital property (marketable securities; for instance) and also cash in hand, the more advantageous tax result might be to provide for a "gift-in-kind" of the marketable securities, instead of an outright gift of cash.

This is so because, on a last-to-die basis, there will be a deemed disposition of the marketable securities, resulting in a taxable capital gain. However, a gift specifically provided for in the Will can also be applied to the deceased taxpayer's immediately preceding taxation year, to the extent that a credit is not fully used in the year of death.[42]

The result is that a gift at "fair market value" of the securities can result in only one-half of the taxable capital gain being included in the income reported on the terminal return, rather than the fully includable amount. This preserves the "tax paid" cash of the estate and reduces the overall "tax-bite".

There are also other elective provisions relating to the gift of capital property to a registered charity. There is a provision which permits the legal representative to make a gift of capital

[41] Subsection 118.1(5)
[42] Subsection 118.1(4)

property to a charity and to designate an amount not less than the adjusted cost base of the property and not greater than the fair market value of the property.[43] This elective provision permits the estate to determine the actual amount of the capital gain to be realized on the disposition of the property. The value of the charitable tax receipt would, of course, be equivalent to the amount designated on the transfer.

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[43] Subsection 118.1(6)

**7. Stop-Loss Provisions**

There are two sets of rules which can have a dramatic impact on the tax consequences arising from the estate plan. These rules are extremely complex and, in effect, beyond the intended scope of this paper.

The stop-loss provisions which would apply are contained within the following provisions of the Act:

- Subsection 40(3.6), affiliated stop-loss rules; and
- Subsection 112(3.2) capital dividend stop-loss rules.

The reader is directed to an excellent paper on this area.[44] Care should be taken in structuring a post-mortem re-organization so that anticipated losses are not unknowingly restricted or lost in the overall estate plan.

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*About the Author*

*Larry Frostiak, CA, CFP, TEP, received his Chartered Accountancy Designation in 1981 and is a founding partner of Frostiak & Leslie Chartered Accountants Inc. in Winnipeg. He specializes in tax planning for owner-managed corporations and their shareholders, corporate reorganizations, business sales and acquisitions, and estate planning and taxation of family trusts. Larry also provides financial and wealth management services to assist clients with "tax-efficiently" structured portfolios and financial, estate, and succession issues. Mr. Frostiak has instructed at the Canadian Institute of Chartered Accounts' In Depth Tax Course and has lectured for the Winnipeg School Divisions (Continuing Education Programs) and various accounting courses for the University of Manitoba. He has also authored many published articles on tax issues over the past several years.*

You can find out more about the author at http://www.cafinancialgroup.com.

[44] POST MORTEM PLANNING FOR PRIVATE COMPNAY SHARES: THE NEW REGIME, Jim Barnett, Peter Everett, Chris Ireland, and Shelagh Rinald. Canadian Tax Foundation Conference Report, 2002