Kathryn Edwards

Estate Planning and Tax Implications Upon Death

As we, our parents, and society in general continue to age, professionals are more frequently finding themselves addressing the estate planning concerns of their clients. In this regard, this article is intended to provide you with a general understanding of the basic tax implications to consider during the estate planning process.

"Estate planning" is the process of planning for the disposition and allocation of a person's estate upon death. It is just one component of the more comprehensive process of "financial planning," which includes planning and management of your finances throughout the course of your life. Common estate planning objectives include:

- minimizing income tax upon death;
- minimizing probate fees upon death;
- simplifying your affairs to reduce the burden on surviving family members; and
- planning for the distribution of assets in accordance with your wishes.

While each individual will weigh these objectives differently, individuals embarking on the estate planning process would be well advised to familiarize themselves with the tax implications that would arise upon death. This is the focus of this article.

Income Tax Implications upon Death

In general, when a person passes away, all owned assets are deemed to be disposed of at their fair market values ("FMV"). Further, the FMV of RIFs and RRSPs or similar registered funds are deemed to be paid out at that time. As a result, the final personal tax return of the deceased can reflect a significant amount of additional income, thereby resulting in unusually high income taxes for that year. An exception to these rules arises when assets are left by one spouse to the other. In that case, the assets are generally deemed to transfer at their cost bases for tax purposes. In these circumstances, the additional income tax would not arise until the second spouse passes away.

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Example

Let's assume Uncle Bill passed away November 30. A widower at the time of his death, he left all his assets to his three adult children. He owned his own home (FMV $300,000); had a RIF valued at $145,000; owned a piece of vacant land in Qualicum (FMV $130,000), which he had purchased 20 years ago for $20,000; and had $60,000 cash in the bank.

When Uncle Bill's final personal tax return is filed, the following income would be reported on his return, *in addition* to his "normal" income, received up to the date of death.

Uncle Bill's Final Tax Return

Capital Gain on Home	Not taxable; qualifies as Principal Residence
RIF Deemed Redemption (FMV of RIF)	$145,000
Capital Gain on Vacant Land	$130,000 FMV - $20,000 cost base x 50% Capital Gains Inclusion Rate $55,000
Total Additional Income to Report	$200,000
Assume Taxed at Top Rate for 2002	x 43.7%
Total Additional Tax in Year of Death	**$87,400**

Managing Taxes that Arise upon Death

The $87,400 of additional taxes that would arise upon the death of Uncle Bill would be payable when his final personal tax return is due—in general, the later of April 30 of the following year, or six months from the date of death. One concern held by many individuals is "how to pay for the additional tax." In Uncle Bill's case, there is clearly sufficient cash on hand to cover the tax liability. In other cases, however, the assets on hand may not be liquid in nature; funds may not be readily available to pay

the tax. This can leave the beneficiaries of the estate in a bind.

An estate plan may consider the following methods to manage the potential tax liability.

1. **Life insurance**
   A life insurance policy could be purchased, with a payout in the amount equal to the estimated tax liability upon death. In this way, the life insurance proceeds would be used to pay the taxes reported on the final income tax return, and the payment of the taxes would not encroach upon the estate's value. A chartered accountant can help calculate what this estimated tax liability might be.
2. ***Inter vivos* gifts**
   An individual preparing an estate plan may consider giving assets to children during his or her lifetime, to "shift" future appreciation in value to the next generation. It is important to note, however, that before any type of gift is made, you should seek professional tax advice, to ensure that no unexpected income tax is triggered as a result of the gift.
3. **Keep liquid assets**
   If you simply accept the taxes that will be payable, an estate may be structured to ensure that sufficient liquid assets—cash—are on hand so that at the time of passing, the taxes can be easily paid. As with the first point above, you would first require a calculation of the estimated tax liability upon death, to determine how much cash should be kept on hand.

Joint with Right of Survivorship: a Caution

While the matter of probate fees is beyond the scope of this article, the potential tax implications of issues relating to probate are not. In this regard, one widely discussed approach to reduce probate fees is to hold assets "jointly." Assets held jointly with right of survivorship can avoid probate fees because they pass directly to the surviving owner.

It is important to note, however, that *income tax* is not avoided in this way. Assets are still deemed disposed of at their FMV upon death—other than between spouses—even if jointly owned, and can trigger capital gains on the final return. In addition, any transfers to "joint ownership" must be done with extreme caution and with appropriate attention to tax implications for the following reasons.

- A *bona fide* transfer of property into joint tenancy is a disposition for income tax purposes that may trigger tax unless the new joint tenant is a spouse and the spousal rollover applies. In any case, income attribution can apply thereafter.
- Principal residences put into joint ownership may reduce the overall principal residence exemptions because each individual is only allowed to have one principal residence.
- Probate fees may not be forever avoided. At a minimum, they will ultimately occur on the death of the last registered owner.

Assets held jointly...can avoid probate fees... .

Transfers of assets into joint ownership can result in unintended income taxes; we strongly recommend that professional tax advice be obtained before you undertake such planning.

The above comments are not an exhaustive list of considerations that should be made when undertaking an estate plan and, in fact, highlight only a few specific tax implications in a general way. When undertaking any part of an estate plan, it is always recommended that you involve the right professionals, to ensure that the specifics of a person's legal requirements are appropriately addressed. ▲

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LAND TITLE BRANCH ANNOUNCEMENT

On November 29, 2002, the Application Receiving Centre at the Government Agent's office in Nelson will stop receiving applications for the Kamloops Land Title office.

All applications that were submitted to the Kamloops Land Title office through the Nelson Application Receiving Centre on or before November 28, 2002, must be dealt with directly with the Kamloops Land Title office after December 2, 2002. All applications dealing with titles in the Nelson Land Title District are to be submitted for registration commencing December 2, 2002, to the:

Kamloops Land Title Office
#114 – 455 Columbia Street
Kamloops, BC V2C 6K4
Telephone: 250 828-4455.