The TaxLetter®

Vol. 39, No. 2 Your Guide to Tax-Saving Strategies February 2021

TAXSTRATEGY

Death & Taxes

Planning Tips for your Will

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The last year has found us really thinking about our mortality and our legacy. How do we provide for our loved ones? For many Canadians out there, getting a will in place has been at the bottom of many "to do" lists. But based on how busy my Wills and Estates Group has been the last year, it looks like it has jumped to the top of many lists. When we think about planning our Will, we think about who will take of our kids, and to provide for them. It's also possible that one would tend to worry about ensuring there is enough left over for your family members once the taxman gets his piece of the pie. So how do you plan your Will in the most tax efficient manner?

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The Spousal Gift

As you all know, Canadian tax rules provide that when you pass away, you are deemed to have sold all of your assets immediately prior to your death. To the extent that any of your assets have a pregnant gain, then your estate will be subject to capital gains tax. On the bright side of things, at least your beneficiaries get to inherit your assets with a bumped-up cost base and there is no tax to them. There is, however, one important exception to this deemed capital gain. You can defer your death tax exposure by making your spouse the beneficiary of your estate, or perhaps better still, you can leave your assets in a qualifying spousal trust. There is no election that your estate need make; it's an automatic deferral to the extent you leave assets to your spouse or a spousal trust.

Specifically, the tax rules provide that bequests to a spousal trust (or to your spouse outright) will not trigger capital gains tax on your death so that assets transferred to the spousal trust will occur on a tax-deferred basis.

The bonus of a spousal trust is that you can choose trustees to protect the surviving spouse against poor financial decisions, or any undue influences. As well, you can ensure that the surviving spouse will not be able to transfer assets to undesired beneficiaries (for example, if he or she were to get remarried and decide to leave your assets to their new spouse).

But you must be certain that the spousal trust qualifies for the tax-deferred treatment; otherwise, no tax-deferred rollover upon your death will be available.

Specifically, the spousal trust must meet the following requirements:

☛ The spouse is entitled to receive all of the income of the trust while he or she is alive (but this does not include capital gains).

☛ No other person (including kids) may receive or otherwise obtain the use of any income or capital of the trust.

Note: just because no one else is allowed to receive the capital of the trust does not mean that the spouse is automatically entitled to the capital. Which means that you can provide that there is no power to encroach on capital so that the nest egg stays safe for your children and your spouse gets the benefit of the income during their lifetime.

In other words, as long as no other person received or obtains the use of the capital, the spousal trust will not be disqualified.

In order to make sure that you do not stray from these requirements, care should be taken when drafting your will and the clauses relating to the spousal trust.

For example, if the spousal trust allows for the trustees to loan funds on an interest-bearing basis to a relative, this could be interpreted as allowing someone other than the spouse to receive or obtain the use of the capital (it may be okay, however, to loan funds on commercial terms; however, you should check with your advisor).

Happily (relatively speaking, of course), a spousal trust can provide for certain testamentary debts to be paid, i.e. funeral expenses and income taxes payable for the year of death and prior years.

Testamentary Trusts

Before 2014, one of the most important strategies when tax planning your will was the "testamentary trust", as such trusts were separate taxpayers, with access to the graduated rates. So, by leaving assets in a testamentary trust for your kids, instead of giving them outright to them, the kids could "income split" with the estate. This opportunity was even more lucrative because the estate can choose to declare and pay tax on its income even though it is actually paid out to beneficiaries. And the more testamentary trusts you created in your will, the more you had access to the graduated tax rates. However, that was then, and this is now. However, as of 2016, testamentary trusts no longer benefit from graduated tax rates (in addition to no longer being exempt from making tax installments or having an off-calendar year end). As a result, testamentary trusts are subject to a flat, top-tax rate. The only exception to this new rule is that the estate designate itself as a "graduated rate estate" (GRE) and thereby take advantage of the graduated tax rates for the first 36 months after death.

There are specific rules that relate to GREs, namely that there can only be one GRE per deceased person. It must meet the following criteria:

1. the estate must designate itself as a GRE on the first year's tax return;

2. no other estate of the individual can be designated as a GRE; and

3. the estate must use the deceased's Social Insurance Number on each tax return during the 36-month period following his or her death.

Another benefit is that GREs are also the only type of testamentary trust that can utilize capital loss carry backs, which allows the GRE to carry capital losses back to the deceased's terminal year under certain post-mortem tax strategies (this is especially important if an estate owns shares in a private company, as such a strategy can help avoid double taxation). Additionally, GREs enjoy various administrative benefits, such as being entitled to refunds beyond the normal assessment period and an extended notice of objection deadline.

I would also note that if you are philanthropic, a GRE provides for more flexibility in claiming donation tax credits. Specifically, the tax credit can be claimed by the GRE in the year the donation is made (or any of the following 5 years), it can be carried back to previous year of the GRE, or even to the final tax return of the deceased (or a year prior to death).

Probate Planning

In Ontario, a probate tax of 1.5 per cent will be payable on the value of your assets that go through probate.

However, if you own shares of private companies, you should ensure that you have a Secondary Will that deals only with those shares.

Why? Well, you may be surprised to know that shares of private companies do not require a probated will in order to effect a transfer to the beneficiaries (unlike bank accounts or real property).

Accordingly, by segregating your private company shares in a separate will, you can avoid probate tax on the value of your shares.

This can be substantial if the bulk of your wealth is tied up in private company shares. Therefore, if a Secondary Will is drafted to deal with your shares, then the application for probate will only be made in respect of your assets in your Primary Will. NOTE: your Secondary Will can also deal with other assets that would not normally require a probated will, such as loan receivables, jewellery, art or other personal assets.

I mentioned above that a probated Will would be required in order to transfer real estate to your beneficiaries. However, it is possible to save on probate fees on your home or other personally owned real estate by having a bare trustee company on title, and the shares of such bare trustee company be dealt with under the Secondary Will.

Since you won't need to change title to the property on your death (as it will continue on in the name of the bare trustee company), a probated Will is no longer required for that purpose.

RRSPs and RRIFs

I recommend that you designate a beneficiary of a Registered Retirement Savings Plans (RRSP) or Registered Retirement Income Funds (RRIF) directly with the custodian itself rather than in a will.

Not only will this avoid probate fees, but if you designate your spouse as a beneficiary, the value of your RRSP or RRIF will not be included as income on your final return as there is a deferral of tax for transfers to spouses.

If your spouse passes away before you, or you get divorced, you can designate a child or grandchild who is "financially dependent" on you so that the RRSP will be taxed in the hands of the low tax rate of the child or grandchild (Note - the financially dependent child or grandchild can also specify a special annuity which will enable them to defer this tax while they are minors - or indefinitely if they are mentally or physically disabled).

"Financially dependent" usually means that the child or grandchild's income does not exceed the basic personal amount.

A few more tax saving strategies for your will include:

- ♦ if you own income and non-income-earning assets, it is possible to leave the income-earning assets to children with low income. This is because income from bequests to high-income children will, of course, be added to their other taxable income, thus resulting in a significant tax exposure.
- ♦ Leave your residence to a beneficiary that will be able to claim the principal residence exemption.
- ♦ If someone owes you money and you wish to forgive the debt, the best way to do this could be in your will so as to avoid certain debt forgiveness rules.

By properly tax planning your Will using some of the above strategies, you can at least take comfort that upon your death, you will be leaving a larger inheritance to your family, and not to the CRA. ❑