

FILING TAX RETURNS FOR THE DECEASED AND THE ESTATE

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This paper is intended to provide a general overview of the preparation of the tax returns to be filed on behalf of the deceased taxpayer and the estate. While it deals with a number of comprehensive issues, it is not an exhaustive reference list.² In light of the subject matter addressed, the paper is, unfortunately, quite technical.

Please note that this paper does not purport to offer tax advice. Each individual estate is unique and professional accounting advice should be sought with respect to taxes payable and the filing of tax returns.

Subsection 248(1) of the *Income Tax Act*³ (the “*Act*”) refers to the term “common law partner” to mean a person who cohabits at that time in a conjugal relationship with the taxpayer for at least one year or the parent of a child of whom the taxpayer is the parent. Whenever the term “spouse” is used in this paper it also refers to a common law partner.

Duties of the Legal Representative

Under the *Act*, it is the responsibility of the legal representative (legal representative refers to an estate trustee or the administrator of the estate if probate is not required) to file all required returns for the deceased on a timely basis, pay all tax owing, and advise the beneficiaries whether the amount they receive from the estate is taxable. The legal representative may be responsible for filing up to four returns in the year of death, in addition to any returns not filed for previous years.

The liability of the legal representative requires that this duty is completed in a prudent manner. To the extent that assets have been distributed and taxes owed and there are insufficient assets left in the estate, the legal representative is personally liable for any shortfall and for any interest and penalties incurred, with such liability not exceeding the value of property distributed by the legal representative. Because of this, it is prudent for the legal representative to hold back a sufficient portion of the estate funds until a final clearance certificate has been received from Canada Revenue Agency⁴ (“**CRA**”).

The beneficiaries of an estate may also be liable for taxes even after the assets have been distributed to them, as creditor’s claims including outstanding tax liabilities have precedent over the rights of a beneficiary to his or her bequest. Additionally, the *Act* has

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² See Anne E.P. Armstrong, ed. “*Estate Administration: A Solicitor’s Reference*” looseleaf (Scarborough, Ont.: Carswell, 2007), “Tax Returns”, 5-1 for more detail.

³ R.S.C 1985, c. 1 (5th Supp). Version in force in January 2, 2015 is referred to.

⁴ *Act*, s. 159(3), C.R.A. Income Tax Information Circular 82-6R10, “Clearance Certificate” (January 3, 2014).

several rules that specifically provide for the joint and several liability for income tax owing with respect to Registered Retirement Income Funds (“**RRIF**”) and Registered Retirement Savings Plans (“**RRSP**”).⁵ If the CRA cannot collect from the estate or the legal representative, they will try to collect from the beneficiaries. The beneficiaries may be liable to the extent of the value of the assets from the estate they received and possibly the gains or income from those assets. The liability includes liability for the year of death and all prior years.

A legal representative should seek proper tax advice when completing the deceased’s tax returns or the tax returns for the estate. Aside from their own liability, failure to take measures to reduce or defer taxes could make the legal representative vulnerable to criticism by the beneficiaries of the estate.

Returns to be Filed

Upon the death of a person, two taxpayers are created. First, the income earned from January 1 of the year of death to the date of death is reported in the terminal return. Second, the date after death is the first date for the new taxpayer, the estate. The estate taxpayer is taxed in accordance with the principles of the taxation of trusts.

1. Prior Returns not Filed

Any individual tax returns which the deceased has not filed for the years prior to the year of death are essentially late and due immediately. They must be filed within six months after the date of death. CRA provides the required T1 forms for all previous years. As different rules apply to different tax years, the legal representative has to be cognizant of the applicable tax rules for the year of filing.

2. The Terminal Tax Return

If all previous years’ returns have been filed, the first return to be filed as a result of death is an individual tax return for the period commencing from January 1 of the year of death to the date of death. The *T1 General Income and Benefits Return* is the form filed.

The terminal tax return must be filed by April 30th of the calendar year following the year of death or six months after that date of death, whichever one is the latter. For example, if the person died within the period from January 1 to October 31, the due date of the return is April 30 of the following year. If the person died within the period from November 1 to December 31, the terminal tax return is due six months after that date of death.

⁵ See *Belanger v. The Queen*, 2007 TCC 502(CanLII), ss. 160.1, 160.2, 160.21 of the Act.

If the deceased or the deceased's spouse was carrying on a business or earned business income, the deceased may qualify for an extension for filing. If the deceased died within the period from January 1 to December 15, the tax return is due June 15 of the following year. If the deceased died within the period from December 16 to December 31, the tax return is due six months after that date of death.

Deadline for a tainted spousal trust

If the deceased's will or court order creates a testamentary spousal trust and it turns out to be a tainted spousal trust (i.e. income from the trust could go to someone else other than the surviving spouse) the filing deadline is 18 months after the date of death.

It is important to note that payment due dates may differ from filing due dates.

3. Optional Returns for the Deceased (Additional T1 Returns)

The *Act* provides for optional returns to be filed to reduce or eliminate tax for the deceased. Filing a separate return for these sources of income reduces the total income that would be reported in the terminal return. Filing a separate return or returns provides the legal representative with another standard set of tax credits and deductions as if it were another person filing a return. These returns are returns for the deceased taxpayer and not the estate.

a. Special Return for "Rights or Things" (s. 70(2), (3) of the *Act*)

This section of the *Act* provides that where a taxpayer died leaving "rights or things" that if realized would be included in the deceased's income for their terminal year, the legal representative may elect to file a separate tax return or transfer the "rights or things" to beneficiaries directly to be include in the beneficiaries income and not included as part of the deceased's income.

"Rights or things" is not defined in the *Act* but has been found to include dividends that have been declared but not paid prior to the death, unpaid salary, unemployment insurance benefits, Canada Pension Plan ("CPP") payments, vacation pay not taken, and commission wages for pay periods that ended before the taxpayer died.⁶

This return has to be filed either one year after date of death or 90 days from the date the CRA has mailed out the notice of assessment regarding the terminal return, whichever one is the latter.

⁶ Interpretation Bulletin IT-212R3.

b. Return for Income from Partnerships and Proprietorships (s. 150(4) of the Act)

This return can be filed when a partner or proprietor dies after the date that ends the fiscal period of the partnership or proprietorship but in the same calendar year where the fiscal period occurs, the legal representative may elect to file a separate T1 return by the later of 6 months after death or June 15 of the year following death.

c. Return for Income from Trusts (s. 104(23)(d) of the Act)

If the deceased was an income beneficiary of a testamentary trust and dies at the end of a fiscal year of the trust but in the same calendar year of which the fiscal period occurs, a separate T1 return may be filed including the income from the close of the trust's fiscal year to the date of death. This return is due the same time as the terminal return.

Penalties for Late Filing

The penalty for late filing is 5 percent of the unpaid tax at the date the return was due to be filed, plus 1 percent of the unpaid balance for each full month that the return was late filed. The legal representative can complete a Form RC4288 (Request for Taxpayer Relief) requesting that any interest or penalty owed be waived and explaining the reason for the late return.

Calculating Income for Terminal Tax Year

Canadian residents are taxed on their worldwide income. A non-resident will only be subject to tax in Canada on taxable income earned in Canada and not worldwide income. For the purpose of this paper, it is assumed that the deceased was a Canadian resident.

Confirming Income in the Year of Death

Income received by the deceased from January 1 of the year of death to the date of death is included in the terminal return. Section 3 of the *Act* provides a list of possible sources of income that may be included in a tax return. Upon death, a deemed realization is immediately triggered for non-depreciable capital property, depreciable capital property, and RRSPs. After January 1, 2016, when the spouse beneficiary of a spousal trust dies, for that year trust income (including capital gains) from the spousal trust will be included in the deceased spouse beneficiary's terminal return and not the spousal trust.

Legal representatives should use the deceased's prior filed returns for reference to assist in ascertaining the deceased's income and sources of income in earlier years.

The legal representative should collect all T slips, which may mean requesting them from the payor directly but if the payor is unable to supply a T slip, confirmation by letter is also acceptable. The legal representative can obtain a Canadian Pension Plan benefits slip from Service Canada Centre directly.

Source of Income

1. Periodic Payments (s. 70(1) of the Act)

Income which is payable on a periodic basis and accrued to but are not yet due on the date of death, such as interest, rent, royalties, annuities, or remuneration from employment are income earned by the deceased prior to death and are included in the terminal return.

2. Capital Property

The deceased is deemed to dispose of all his depreciable and non-depreciable capital property at fair market value immediately before his death under section 70(5) of the *Act*. To avoid a deemed disposition for the deceased, non-depreciated capital or depreciated capital may be transferred to a spouse or spousal trust.⁷ Intergeneration transfer of farm property may also be allowed if all qualifying conditions are met.⁸

The deemed disposition can either be considered a capital gain or a capital loss. Taxable capital gains realized on the actual sale of capital property prior to death are included in the terminal return. Unless the legal representative takes advantage of a tax free roll over, the taxable capital gains from the deemed disposition are included in the terminal return.

Principal Residence

Paragraph 40 (2)(b) of the *Act* provides that if the deceased owned and inhabited a principal residence at the date of death, the entire capital gain with respect to that residence is exempt from taxation.

If the principal residence is jointly owned by the deceased and his or her spouse, it is transferred to the spouse or a spousal trust. If the principal residence is not transferred to a spouse or a spousal trust, the legal representative files a Form T2091 with the final return.

⁷ s. 70(6) of the *Act*.

⁸ ss. 70(9) and 70(9.01) of the *Act*.

3. Eligible Capital Property

Eligible capital property refers to intangible capital property associated with a business, such as goodwill or a franchise. If the property is passed to someone other than a spouse or to a corporation formerly controlled by the deceased, the deceased is deemed to have disposed of the property and to have received proceeds from the disposition equal to four-thirds of the cumulative eligible capital multiplied by a proration factor reflecting the fair market value of the property relative to the fair market value of the business carried on before death.⁹

4. Land Inventories and Resource Property¹⁰

Land inventories include such things as speculation of land. Resources properties include oil and mineral rights. Pursuant to subsection 70 (5.2) of the *Act*, the deceased is deemed to have disposed of all such property immediately before death unless it is transferred to a spouse.

5. Reserves¹¹

Pursuant to subsection 40(1) of the *Act*, a "reserve" is a deduction based on the unpaid portion of the purchase price of certain types of property that were sold over the year but the purchase price is receivable over several years. In the year of death, the only reserves which are allowed as deductions occur when an amount receivable is transferred as a result of the deceased's death to his spouse or a spousal trust and an election must be made, pursuant to subsections 72(1), (2) of the *Act*. However, income for reserves established in prior years must be included as income in the year of death.

6. Debts Forgiven on Death

The *Act* provides that where a debt owed by a taxpayer is settled in whole or in part without full payment by the debtor, the amount forgiven is applied first to reduce certain losses of the debtor and then to reduce the cost of capital property of the debtor. However, where a debt is forgiven on death or the debtor receives the debt as a bequest or on intestacy, CRA will not apply this rule. Debts that are capital property are deemed to have been disposed of at fair market value immediately before death and may be included in a "rights or thing" return.

⁹ s. 70 (5.1) of the *Act*, Interpretation Bulletin IT-136R6.

¹⁰ Interpretation Bulletin IT-125R4.

¹¹ Interpretation Bulletin IT-236R4.

7. Pensions and Death Benefits¹²

There are many applicable rules and tax filing options when it comes to reporting income from various types of pension plans and the receipt of death benefits. These types of decisions will impact how much tax a deceased taxpayer or his or her estate may be liable for. Beneficial tax advice could minimize taxes in both the terminal year and for the estate returns.

A death benefit is defined in the *Act* as the gross amount received on or after the death of an employee in recognition of his or her service. A qualifying death benefit is included as income in the terminal return. If the benefit is paid as a lump sum directly to the RRSP/RRIF of a surviving spouse, a spousal rollover exists and is not included in the terminal return. The CPP payment received in the last month of the deceased's life is included as income in the terminal year and may be included in a "rights or thing" return to tax advantage of the tax credit.

The CPP death benefit of a maximum of \$2,500, post growth of a RRIF and a lump sum payment of a Registered Pension Plan is filed by the estate and included in a T3 return.

8. Life Insurance¹³

Pursuant to s. 148(1), (4) of the *Act*, payment of insurance proceeds generally should not be taxable and should not attract tax liability in the terminal return.

9. Dividend Income

Dividends declared and paid out to the date of death are included in the terminal return. Unpaid declared dividends may be claimed as "rights or things".

10. Income from Farm Crops¹⁴

When a taxpayer dies with an interest in a farm crop that is sown but not harvested, the estate trustee(s) may decide whether to include the value of the unharvested crop in the deceased's income. If the estate trustee does so this will reduce the amount to be included in the income of the deceased's estate or beneficiaries when the crop is harvested and sold. If the farm land is sold before the harvest, no amount in respect of the crop should be included in the income of the deceased, the estate or the beneficiaries (unless the agreement of sale specifies the crop's selling price).

¹² Interpretation Bulletin IT-508R.

¹³ Interpretation Bulletin IT-430R, IT-244R3.

¹⁴ Interpretation Bulletin IT-234.

11. Employee Stock Options¹⁵

Pursuant to s. 7(1)(e), if an employee owns unexercised rights under a stock option agreement immediately before death, a benefit equal to the stock options fair market value (less any amount paid to the deceased to acquire rights) is deemed as income for the terminal year.

12. RRSP/RRIFs

Discussed below.

13. Rights and Things

Discussed above.

14. Income from Partnerships

Discussed above.

15. Income from Trusts

Discussed above.

Tax Treatment of RRSPs¹⁶

According to the general rule, the fair market value of the RRSP is included in the income of the deceased for the terminal year unless it otherwise qualifies to be transferred. Losses to the investments which occur after death but before the distribution to the beneficiaries could not previously be deducted from the income. However beginning in 2009, where the final distribution from the deceased person's RRSP or RRIF occurs, losses in the plan can be carried back and offset the income inclusion of the RRSP or RRIF in the year of death.

1. If the RRSP passes to designated beneficiaries other than the deceased's spouse or dependent children/grandchild

The fair market value of all the property of the plan must be included in the terminal return. The estate bears the primary liability for the taxes payable in respect of the RRSP unless the will specifically provides otherwise. This may be a large tax burden to the deceased taxpayer.

¹⁵ Interpretation Bulletin IT-113R4.

¹⁶ See CRA, "Death of an RRSP Annuitant," RC4177 (E) Rev.06.

2. If the RRSP passes to the Spouse

The payment qualifies as a refund of premiums (it can be deducted from the deceased's income included in the terminal return and added to the income of the recipient) and the amount paid out of the RRSP to the spouse is taxed in the spouse's hands. The spouse can use the all or part of the proceeds as income or to defer taxes, depending on their age, the spouse can purchase an RRSP, RIF or annuity.

3. If the RRSP passes to the deceased's dependent children/ grandchildren

A child or grandchild is a dependent if they met the requirements under the *Act*. All or a portion of the payment qualifies as a refund of premiums and are therefore taxed in the hands of the beneficiary. Any balance is taxed in the hands of the deceased.

The payment of related taxes can be deferred in two circumstances:

- i) The funds can be used to purchase a qualifying annuity for a term of 18 years minus the dependent child or grandchild's age; or
- ii) If a child or grandchild is physically or mentally disabled and his or her net income is not more than the basic personal amount specified in the *Act*, the RRSP may be transferred without tax to the RRSP of the child, to purchase a RIF or a life annuity. The RRSP may also be rolled over into such a child or grandchild's Registered Disability Saving Plan ("RDSP"). The amount of the RDSP rollover must be reported on both the deceased and the child or grandchild's income tax and benefit return.

4. RRSP passes to the estate

When the proceeds of an RRSP are paid to the estate of the deceased, the amount paid is included in the deceased's income for his final return.

However, the legal representative and the spouse, or a dependent child or grandchild, may jointly elect that the amounts received, or a portion of the amount received by the estate, to be a refund of premiums to the beneficiary and are therefore deemed to be received by the spouse, or dependent child or grandchild.¹⁷

5. Contribution in Terminal Year

The legal representative is permitted to make contributions to a spousal RRSP established by the deceased person for the surviving spouse if there is contribution room. The

¹⁷ ss. 146 (8.2) (b), 146(8.9), 146(8.91) of the *Act*.

contribution can be made in the year of death or during the first 60 days after the end of that year.

6. Matured RRSPs that have started to pay retirement income

Generally, the fair market value of all remaining annuity payments under the RRSP is included in the terminal return as well as the amount the deceased received from the RRSP during that year.

If the spouse is the sole beneficiary of the RRSP, the deceased is not considered to have received the fair market value of the RRSP at the time of death. The RRSP continues and the spouse is the successor annuitant and all payments after that date of death are made to the spouse and that income is reported in the spouse's return. Being appointed the successor annuitant is not a refund of premiums and cannot be rolled over to a RRSP, RRIF, or life annuity.

Where the estate is entitled to receive amounts out of or under the RRSP for the benefit of the deceased's spouse but the spouse has not been appointed the successor annuitant, the spouse and the legal representative may file a joint election that the spouse shall be deemed to have become the successor annuitant.

Where the commuted value of the annuity payments are payable directly to a dependent child or grandchild as a result of being designated, the amounts paid and which qualify as a refund of premiums are include in their income and not in the deceased's income for the year of death. If the dependent child or grandchild has a physical or mental disability, tax may be deferred by the purchase of an annuity.

Where the estate is entitled to receive amounts out of or under the RRSP but have not been designated, a dependent child or grandchild and the legal representative can file a joint election that all or a portion of the proceeds received be deemed to be a refund of premiums to the child or grandchild.

Tax Treatment of RRIF

The general rule is that the fair market value of the RRIF is fully taxable to the deceased at date of death unless it qualifies as a rollover to a spouse or a dependent child or grandchild.

Where the deceased elected to have the spouse become the successor annuitant of the RRIF, payments after death are taxed in the hands of the spouse. Where the deceased designated the spouse to be the beneficiary of the RRIF proceeds, the proceeds are taxed at the hands of the spouse.

Where the RRIF value is payable directly to a dependent child or grandchild, the proceeds are considered a refund of premiums and taxed in the hands of the child or grandchild. If the dependent child or grandchild has a physical or mental disability, tax may be deferred by the purchase of an annuity.

If the proceeds of the RRIF are paid to the estate in circumstances in which all or part would qualify as a refund of premiums if paid directly to a dependent child or grandchild, the legal representative and the beneficiary can file a joint election that all or a portion of the proceeds received be deemed to be a refund of premiums to the child or grandchild and such amount which qualifies as a refund of premiums is then taxed in the beneficiary's hands.

Withholding Tax (s. 153(1) (1) of the Act; Regulations 100(1) (j); (103(6) (d.1))

There is no requirement to withhold the remittance of tax when a taxpayer's RRSP or RRIF is paid out after death to a named beneficiary or to his or her estate. The *Act* only requires that tax be withheld during the lifetime of the annuitant. Plan administrators may not be aware of this distinction.

Tax Credits for Year of Death

1. Personal Tax Credits

When an optional return or returns are filed along with a terminal return, full personal tax credits can be claimed in the terminal return and in the optional returns filed¹⁸.

The credits and deductions to which this rule applies include:

- i) the education and tuition fees credits, including credits transferred from a child or grandchild but not credits transferred from a spouse;
- ii) the disability credit;
- iii) the medical expenses credit;
- iv) the charitable donations credit;
- v) the pension income credit;
- vi) the deductions for employees' stock options, prospectors' shares, and DPSP share distributions claimed on line 249 of the T1 return;

¹⁸ Interpretation Bulletin, IT-326R3.

- vii) the deduction for employee home relocation loans; and
- viii) the deduction for unemployment insurance repayments.

2. Medical Expenses

Pursuant to s. 118.2(2) of the *Act*, in the terminal return the legal representative is entitled to claim a tax credit for medical expenses that may be paid within any 24-month period that includes the date of death. This allows for expenses which were paid after death to be claimed.¹⁹

3. Charitable Donations

This is a common tax planning method used for reducing taxation. Charitable donations made in a will were deemed to be made in the year of death and these tax credits are included in the terminal return. Procedurally, they can only be included once the charity has received their bequest and issued a receipt to the deceased. For deaths occurring after 2015, if the estate is a “graduated rate estate” (i.e. for the first 36 months after the date of the deceased’s death if the estate trustee(s) file to be treated as such) the estate trustee(s) can claim the donation among either the deceased’s last two taxation years, the year the donation was made, an earlier taxation year of the graduated rate estate, or can carry it forward for up to five years.

Charitable receipts that have been unclaimed for five years proceeding the year of death can be included in the terminal return. A tax credit for charitable donations made in the year of death or under the deceased's will may be claimed up to a maximum of the lower of 100 percent of the deceased's income for the terminal year or and the previous year before death and 75 percent for all other years. Legal representatives may go back and refile previous years’ returns of the deceased to make use of excessive tax credits.

4. Capital Losses and Reserves

Pursuant to s. 111 (2) of the *Act*, all capital losses realized in that year of death, including capital losses created as a result of the deemed realization rules, may be deducted from capital gains realized in the year. For the year of death and the immediately preceding year, net capital losses may be used to reduce income. There is no restriction if there is a carry forward of net capital losses from a year prior to death. Those losses may also be deducted in the return prior to the terminal return.

Other personal tax credits that may be claimed in the terminal year include the Ontario property tax credit, sales tax credit, the Ontario property tax grant, and foreign tax credits.

¹⁹ Income Tax Folio, S1-F1-C1: Medical Expense Tax Credit.

Returns to be filed for Estate and Trusts

The legal representative is required to file a *Trust Information Return and Income Tax Return* (T3) for the estate under the following circumstances:

- a) for the period starting from the date of death and ending with the distribution of the estate if the estate is fully administered within 12 months of the date of death;
- b) for each 12-month period the estate continues; and
- c) for the period commencing with the last 12-month period and ending with the distribution of the estate.

These returns must be filed in every instance if the total income of the estate exceeds \$500; or income is taxable to the estate; or the income paid or payable to any single beneficiary exceeds \$100; or any portion of the income of the estate is allocated to a non-resident.

In a situation in which the estate was distributed immediately, the estate would file a return showing that there was no income generating tax. In some circumstances when the estate has not earned income, and the legal representative has confirmed that the beneficiaries have reported their income earned, the legal representative may feel comfortable not filing a T3 return.

Types of Returns

1. Testamentary Trust

A testamentary trust is a trust that arises under a will or as a result of death. The taxation year of a testamentary trust was any period which the legal representative chooses which does not exceed 12 months (in other words, the legal representative may choose a taxation year that ends on the calendar year, the anniversary of the date of death or any 12-month period starting after the date of death). It must be filed 90 days after the trust's year end. Section 117(2) of the *Act* provided that a testamentary trust is taxed at a progressive rate, however, after January 1, 2016, all testamentary trust income will be taxed at the top marginal rate. Additionally, the taxation year must be the calendar year. Note that, if the estate trustees declare the estate to be a graduated rate estate, it can benefit from the old tax treatment of testamentary trusts for up to 36 months after the deceased's date of death. A deceased may have only one graduated rate estate.

A testamentary trust which is resident in Canada for the trust year and has disabled beneficiaries can elect (along with the beneficiaries) to become a "Qualified Disability

Trust.” Qualified Disability Trusts continue to be taxed at a progressive rate. Any beneficiary of same can only make such an election with respect to one Qualified Disability Trust.

2. *Inter Vivos* Trust

Defined for tax purposes as a trust other than a testamentary trust, usually it is a trust that has been settled during the deceased's lifetime. The fiscal year of an inter vivos trust is the calendar year and it must be filed 90 days after the year end (the end of March). Subsection 122 (1) of the Act provides that an inter vivos trust is taxed at a top marginal rate.

3. Winding Up of Trust

The taxable year ends on the date of the final distribution of assets and a T3 form needs to be filed within 90 days.

A will can also create more than one trust. In the circumstances of multiple wills, the legal representative could file a separate return as each taxpayer and allows income to be taxed at the progressive rate. Commencing in 2016, this will only apply to a graduated rate estate. Additionally, it is unclear if CRA will allow multiple wills to create multiple graduated rate estates; as noted, above a deceased can only have one graduated rate estate.

Penalties for Late Filing

The penalty for failure to file a T3 return on the due date is \$25 a day for each day the return is filed late to a maximum of \$2,500, with a \$100 minimum penalty. A trust which has failed to file a T3 return by the required date is also liable to an additional penalty of 5 percent of unpaid tax at the date, plus 1 percent for each additional full month to a maximum of 12 months that the return was past due.

Taxation of a Testamentary Trust²⁰

A legal representative should have knowledge of the residence status of the beneficiary or trustee and has to be careful to determine if trust income is allocable to the beneficiary or taxed in the trust.

A testamentary trust is deemed to be an individual. As noted above, commencing in 2016, testamentary trusts which are not graduated rate estates will cease being subject to ordinary personal rates with respect to income earned and capital gains reported and will

²⁰ For a more in depth review of the taxation of trusts including residence requirements, see Karen Gibbs et al., *The Practical Guide to Ontario Estate Administration*, (Scarborough, Ont.: Carswell, 2006), “Chapter 8: Roll-Overs and Estate Taxation”.

instead be taxed at the top marginal rate. Note that the trust is not allowed to claim personal tax credits.

1. Accumulated Income²¹

Any trust income which is not paid to a beneficiary in the taxation year is taxed in the estate as income of the estate. A legal representative may elect to deduct this income in calculating the estate income and have the income taxed in the hands of the beneficiary.

If the legal representative on behalf of the estate pays for maintenance in respect to property for the benefit of the beneficiary, that benefit may be reported as income by the beneficiary or the estate can elect that it can be taxed in the trust.

2. Preferred Beneficiary Election

The preferred beneficiary election has generally been eliminated from 1996 and beyond but a joint election by the legal representative and beneficiary may still be available to beneficiaries who have a mental or physical disability and are entitled to a tax credit and in other limited situations.²²

3. Flow-through Provisions of Trust Income²³

In certain conditional circumstances, the source of the trust income is preserved for the benefit of the beneficiary so allowing the beneficiary to claim a dividend tax credit.

Taxable capital gains, foreign source income, and pension income may also flow through the trust to the beneficiary. The estate is allowed to deduct the amount payable to the beneficiaries and deduct expenses relating to property held by the beneficiary and for use by the life tenant.

Note that after 2016, beneficiaries will not be able to claim “investment tax credits” from the estate, unless the estate is a graduated rate estate. It is unclear whether this is the same as a dividend tax credit, as the IT no longer refers to dividend tax credits.

4. 21 year deemed disposition rule

Pursuant to ss. 104(4) and (5) of the *Act*, there is a deemed disposition of capital property 21 years after January 1, 1972 or from the date of death, whichever is the latter.

²¹ Interpretation Bulletin IT-286R2.

²² S. 104(14) of the *Act* and Interpretation Bulletin IT-394R2.

²³ Interpretation Bulletin IT-381R3.

Tax Treatment of Estate Trustee Compensation

Legal fees associated with the normal tasks of administering an estate or pertaining to the investment of capital is rarely deductible. Estate trustees' fees are also rarely deductible unless they are incurred for the purposes of earning income.²⁴ Estate trustee compensation is fully taxable in the hands of the estate trustee.

HST

Generally, H.S.T. does not apply when a taxpayer dies and transmits money to his or her estate or property is transferred to beneficiaries, unless it is a supply made in the course of commercial activity.²⁵

Clearance Certificate

The *Act* mandates that a legal representative must obtain a clearance certificate before distributing any property under his or her control if he or she wishes to avoid being personally liable for any unpaid taxes, interest or penalties.²⁶

This is not to say that an estate cannot be distributed without a certificate, for example, if the legal representative is also the sole beneficiary they may not have an interest in protecting themselves from personal liability.

A clearance certificate certifies that all taxes, CPP contributions, unemployment insurance premiums, interest and/ or penalties assessed and chargeable or payable out of any property of the deceased have been paid or that security for payment has been accepted.

A clearance certificate is applied for when all requisite income tax returns have been filed, taxes paid, and assessments received. This also applies to a T3 trust return when income has been taxed in the hands of the trust.

Further Information

The CRA provides a detailed line- by- line guide to filing a terminal tax T1 return: [T4011\(E\) - Preparing Returns for Deceased Persons 2014](#) and a line-by-line guide to filing a T3 return: <http://www.cra-arc.gc.ca/E/pub/tg/t4013/t4013-e.html>.

²⁴ Interpretation Bulletin IT-99R5.

²⁵ *Excise Tax Act*, R.S.C. 1985, c. E-15, s. 267 (1) (a).

²⁶ ss. 159(2), 159(3) of the *Act*.