

# Taxation of the Average Estate

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# **TAXATION OF THE AVERAGE ESTATE**

## **I. INTRODUCTION**

The purpose of this paper is to take a brief look at taxation issues and topics that most lawyers will encounter on most estates. It is geared towards lawyers who are new to estate and taxation practice or who don't specialize in estate taxation. It will touch on steps that need to be taken after the death of an individual, as well as some ideas for tax planning before death. The topics are not presented in any particular order or progression; this is a miscellany of topics that I've encountered in my own estate practice.

Obviously a paper of this length cannot include everything there is to know about taxation of estates. The information given here is basic and should provide a starting point for further research. Where appropriate, I've included references not just to the applicable statutes but also to Canada Revenue Agency (CRA) Information Circulars and Interpretation Bulletins and, occasionally, other resources. My goal is to provide enough information for lawyers to identify taxation issues on their files and planning opportunities that exist with their own clients. Using the tax strategies or will planning ideas in this paper may require getting a second opinion from a tax lawyer or perhaps consulting with a tax accountant.

### **A. DON'T GET IN OVER YOUR HEAD**

Lawyers practicing in estate administration and/or estate planning should get to know some experienced tax accountants. Unless the lawyer has a specialty in tax law, he or she must be aware of when he or she is possibly "in too deep" in tax matters. This becomes relevant most often in the planning stages, where the lawyer and client are brainstorming about the best, and most tax advantageous, way to set up the client's estate. It is often a good idea to involve accountants in the discussion. Always keep Chapter 9, Rule 4 (a lawyer must not render advice unless competent to do so) of the Code of Professional Conduct in mind, as follows:

“A common example of a case in which competence may become an issue is the implementation of a transaction having income tax consequences. A lawyer should be continually alert to this possibility and should ensure that, where necessary, the client has obtained appropriate tax advice.”<sup>1</sup>

Also, a lawyer should never prepare tax returns for personal representatives of estates. The best practice would be to advise the executor of the various returns that need to be filed and the deadlines for each of them, and advise him or her to retain an accountant for that purpose. It's acceptable to provide the client with the names of a few competent accountants with whom you have worked in the past. It's also acceptable, if the client wishes it, for you to send a letter of instruction to an accountant on his or her behalf.

## **2. HOW TAX LIABILITY ARISES:**

Canada does not have an inheritance or death tax *per se* in place. This does not mean, however, that the death of an individual has no tax consequences. Tax liability arises because the estate of an individual is deemed to have been disposed of at fair market value immediately before his or her death. All gains and losses must at that point be realized and declared.

This means that the individual's tax-deferred instruments, such as his RRSP, are deemed to have been paid to him immediately before his death, and therefore the deferred tax is payable once he dies. It also means that capital property such as real estate and corporate shares must transfer to someone else (either to his estate or to a beneficiary). If the capital property has appreciated in value, there will be capital gains tax on the increase.

For a detailed discussion about which property owned by a deceased individual that is included in a deemed disposition and which is not, see the CCH Canadian Estate Administration Guide, sections 28930 to 28935.

The death of an individual results in the creation of an entirely new taxpayer, i.e. the individual's estate. Each year, the personal representative of the estate must file a T3

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<sup>1</sup> Code of Professional Conduct, Chapter 9, Rule 4, Commentary 4

trust return for the estate within 90 days of the year end. No T3 return has to be filed if the property in the estate was distributed immediately after death or if the estate did not earn any income.

If the individual has planned in advance, he or she may be able to take advantage of tax strategies such as spousal rollovers, farm rollovers, deductions and exemptions. This paper will look at various tax situations that arise, and illustrate some ways in which proper planning can help to alleviate those situations.

## **II. TAX ISSUES THAT ARISE ON DEATH**

In the first half of this paper I will look at situations that typically arise after an individual has passed away and you have been consulted by the Personal Representative of the estate. While this is not an exhaustive list, it is comprised of many of the questions I encountered most frequently during my estate practice.

### **1. INCOME TAX RETURNS THAT MUST BE FILED WHEN AN INDIVIDUAL DIES**

The executor of an estate is responsible for filing tax returns on behalf of the deceased person and also on behalf of the estate. Most lawyers use a letter to the executor to set out a list of the executor's duties. It's worthwhile to spend time developing a reliable precedent letter of this kind to describe the various returns and the dates by which they are to be filed (perhaps make it part of your retainer letter on estate files).

The various returns that are required upon the death of an individual are summarized as follows:

- a. T1 Terminal Return for the year of death. This is a personal tax return for the individual who died, as opposed to his or her estate. It will cover the period starting January 1 of the year of death and ending on the date of death. The return is due on the later of: a) the normal filing deadline of April 30, or b) six months after death.<sup>2</sup>

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<sup>2</sup> Canada Revenue Agency Information Circular #RC4111 – “What to do Following a Death”