TAXATION ON DEATH: DEEMED DISPOSITIONS AND POST MORTEM PLANNING

Professor Catherine Brown

Faculty of Law

University of Calgary

Tax Law for Lawyers

June 2010

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INTRODUCTION

Two things in life are certain, death and taxes. This paper examines tax liability on death, filing and reporting obligations and options to reduce or avoid tax costs.

The deceased's personal representative has the responsibility of settling the deceased's account with the Canada Revenue Agency (the CRA). A return must be filed for the year of death (the terminal year) and any tax outstanding with respect to that year or earlier years must be paid. As the amount of tax due can vary depending on the terms of the will (or relevant intestacy legislation) and the decisions made by the personal representative, thus understanding and planning for income tax liability in the year of death and throughout the administration of the estate is important.

In general there are three categories of special rules that apply to taxation on death. First, the rules for computing income for the terminal year vary in a number of important respects from those that apply during a taxpayer's lifetime. The most significant of these provide the personal representative with a number of options or elections. Others deem certain types of property to have been disposed of by the deceased immediately prior to his/her death in return for proceeds generally equal to the fair market value of the property. In addition, rules throughout the Act[1] provide special treatment with respect to reserves, the use of capital losses and other deductions and credits in the year of death. Second, a number of provisions provide special tax treatment for specific types of income and property. These include provisions regulating rights to income that is still accruing at the date of the death, other payments that could have been demanded during the lifetime of the deceased (rights and things), capital property, eligible capital property, resource properties and land that is inventory of a business. Finally, there are a number of provisions that allow for the filing of separate returns.

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[1] All references to the "*Act*" and section references are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended, unless otherwise noted.

I. INCOME

1. PERIODIC PAYMENTS

In computing the income of a taxpayer for the year of death, amounts that would have been income for that year, if the taxpayer had lived, must be included. A common example is accrued bank interest. As well, there may be certain amounts that, although not accrued during the taxpayer's lifetime, will be deemed to be income for the terminal year. Subsection 70(1) provides that, income that is payable periodically, but that is still accruing at the date of death, is subject to a notional severance and is deemed to have accrued in equal amounts from day to day. The amount deemed to have accrued up to and including the day of death is included in income for the terminal year[2]. The remaining income belongs to the estate, which is treated as a separate taxpayer under the Act. Examples of periodic payment include amounts that represent accrued but unpaid wages or salaries, interest from bonds, rents, royalties and/or annuity payments.

The inclusion of these periodic payments in income in the year of death is obligatory and there are no special options or elections if income amounts fall within subsection 70(1). As this may not be the case with respect to other income amounts, such as rights or things (discussed below), the scope of the provision is of some importance. The CRA's position with respect to what constitutes a periodic payment is outlined in Interpretation Bulletin 210R2, and can be summarized as follows. Section 70(1) does not apply to amounts that were payable before death, but rather applies to an amount payable on a periodic basis that was not paid to a taxpayer before their death. For example, assume a deceased taxpayer owned a term deposit and interest was payable periodically on an annual basis at calendar year end, the portion accruing from January 1st up to and including the date of death would be included in the terminal return. Also included is any salary or wages accrued from the beginning of the pay period in which an employee dies to the date of death. Any accrued expenses relating to an amount included in income under subsection

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[2] Payments of a periodic nature received by the deceased taxpayer on the actual date of his death were held to fall within the purview of subsection 70(1) per *Estate of R. Fontaine v. The Queen*, 95 DTC 5580.

70(1) can be deducted, for example, interest expense on borrowed monies.

2. RIGHTS OR THINGS

Certain payments that the taxpayer could have demanded during their lifetime are classified as rights and things and are taxed as per subsection 70(2). Any income falling within subsection 70(1) is excluded from subsection 70(2). Examples of rights or things include declared but unpaid dividends, declared but unpaid bonuses, deferred cash purchase tickets and un-cashed matured bond coupons. Furthermore, retroactive salary and wage adjustments are considered rights and things. However, where an employer has a contractual obligation to pay an annual bonus or some other periodic bonus, but the bonus is not declared at the time of death, the amount is treated as a periodic payment and included in income under subsection 70(1)[3]. As the distinction between periodic payments and rights and things can be unclear, the CRA's policy is to resolve any disputes about the genuine nature of the income in favor of the taxpayer. Note that capital property, eligible capital property, land included in the inventory of a business, resource properties and interests in life insurance policies are excluded from the definition of rights or things.

The main difference between rights or things (subsection 70(2)) and periodic payments (subsection 70(1)), is that periodic payments could not have been demanded by the deceased during their lifetime. Thus, if the amount was due or payable before death it will not fall within subsection 70(1). If it was not due before death it will fall within subsection 70(1) only if, as well, it is an amount payable on a periodic basis. In summary if the amount was not payable periodically or it was due before death, it may be a right or thing.

Subsections 70(1) and (2) are obviously tidying-up provisions designed to tax unrealized amounts that would have been included in the deceased's income for the year or for a subsequent year if he or she had lived. Of the two provisions, subsection 70(2) is the more

[3] CRA Views, Ruling 2006-0168181E5. May 31, 2006. In *Tory Estate v. MNR*, [1973] C.T.C. 434, it was held that accounts receivable of a business reporting its income on a cash basis were rights and things.

attractive from the taxpayer's viewpoint. If applicable, the deceased's personal representative may:

i. file a separate return for rights or things;

ii. transfer rights or things to a beneficiary under subsection 70(3); or

iii. include the net value of rights or things in the terminal return.

If the personal representative does not choose either the first or second alternative within one year of the deceased's death, or 90 days from the mailing of a notice of assessment, the third alternative becomes mandatory.

If the personal representative elects under subsection 70(2) to file a separate return for rights or things, tax will be levied as if the deceased were another person. This is advantageous as another set of personal credits (basic credit, spouse or common-law partner credit, age credit, etc) can be claimed to reduce the overall tax liability. In addition, the alternative minimum tax provisions will not apply.

If the option of transferring rights or things to a beneficiary is chosen as per subsection 70(3), income is not realized until the beneficiary disposes of the right or thing. When such a disposition occurs, the amount received on disposition, minus the cost of the right or thing, is included in the beneficiary's income. The new cost to the beneficiary is deemed to be the cost to the deceased plus any costs incurred in acquiring the property from the estate.

Subsection 70(3) applies to rights or things transferred to a beneficiary notwithstanding that other rights or things are retained in the estate. In the CRA's view, it is not possible to file a separate return for some rights or things but include others in the deceased's terminal return. If an election to file a separate return is made, it will, according to the CRA, cover all rights or things that were not transferred to a beneficiary within the year.

II. PROPERTY

1. CAPITAL PROPERTY

A. General

The policy of realizing all future income of the deceased also applies to unrealized taxable capital gains. Subsection 70(5) deems all capital property owned by the taxpayer immediately prior to his or her death to have been disposed of at that time in return for proceeds equal to fair market value. It follows that there may be a capital gain or capital loss, and in the case of depreciable property, a recapture of capital cost allowance or a terminal loss. The deceased's personal representative will normally acquire the property at a cost corresponding to the proceeds of disposition.

If the property is depreciable property of a prescribed class, a further adjustment is required if the fair market value of the property immediately prior to death is less than the capital cost of the property to the deceased. In that case, the beneficiary is deemed by paragraph 70(5)(c) to have acquired the property at a capital cost equal to that of the deceased and the excess of the deceased's capital cost over the deemed proceeds of disposition is treated as if it had been claimed by the beneficiary as capital cost allowance in previous years.[4]

Capital gains that arise by virtue of a deemed disposition under subsection 70(5) may qualify for the $750,000[5] capital gains deduction, for dispositions of qualifying property. Qualifying property includes qualified farm property, qualified fishing property (2006 amendment), and shares of a qualified small business corporation. In addition, if the deceased's capital property is transferred to a trust for a spouse or common-law partner (conjugal trust), under subsection 70(6), the conjugal trust is entitled to claim a capital gains deduction for the taxation year in which the deceased's spouse or common-law

[4] A number of other adjustments may also be required under paragraph 70(5) for certain depreciable assets such as buildings. See generally paragraph 70(5)(a) and subsection 13(21.2).

partner died, to the extent that the spouse or common-law partner would have been able to claim an exemption if the eligible capital gains of the trust had been realized by the deceased's spouse or common-law partner directly [paragraph 110.6(12)(c)].

There are three issues that generally arise around the operation of the deemed disposition rules in subsection 70(5).

1. What is fair market value at death and, in particular, what factors affect fair market value?

2. What assets are considered "owned" by a taxpayer immediately prior to death for purposes of subsection 70(5)?

3. When and under what circumstances will property be viewed for purposes of the relieving provisions in subsection 70(6) as being transferred or distributed as a consequence of death?

i. Fair Market Value

Subsection 70(5) deems capital property of a deceased person to be disposed of immediately before death for proceeds equal to fair market value at that time. In some cases the "value" of the deceased's property will be affected by the fact of death. For example, the deceased may have been a shareholder and the "key man" of an incorporated business. On death, his or her shares are deemed to have been disposed of at fair market value. Of ongoing concern to estate planners is whether transactions involving the corporation that occur either as a result of the death or shortly thereafter should be considered in the valuation of the corporation's net assets and, thus, the deceased's shares. This issue was addressed in *Mastronardi Estate v. R.*[6]

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[5] Increased from $500,000 on March 18, 2007.
[6] [1976] C.T.C. 572, 76 D.T.C. 6306 (F.C.T.D.).

In *Mastronardi*, the deceased died suddenly and without warning. His private company was the beneficiary of a $500,000 life insurance policy on his life. The issue before the Federal Court was whether the life insurance proceeds should be included, for purposes of subsection 70(5), in valuing the shares of the company held by the deceased.

The court held that it wasn't until the instant of death that the company became entitled to the proceeds of the life insurance policy. Since the words "immediately before death" in subsection 70(5) refer to a span of time before death, the words could not be construed to import a requirement that capital property be valued taking into account the imminence of death. It follows that the value of the life insurance policy should not be included in the determining fair market value of the shares.

Any victory won by the taxpayer in the *Mastronardi* decision was short lived. Subsection 70(5.3) now provides that in valuing shares held by the deceased, the cash surrender value of any life insurance policies held by the corporation on the life of the deceased must be considered. The logic underlying this requirement would appear to be that the corporation could liquidate the policy for its cash surrender value immediately prior to the death. For more information, see Information Circular 89-3, August 25, 1989, "Policy Statement on Business Equity Valuations".

This valuation rule was expanded in 2001 to apply when determining the fair market value of any property owned by the taxpayer immediately prior to death including an interest in a trust or partnership. It was also expanded to include life insurance policies held on the life of a related person and to the deemed disposition of trust assets under subsection 104(4).

Notwithstanding the introduction of subsection 70(5.3), the decision in *Mastronardi* remains important for its discussion of the point in time at which a disposition under subsection 70(5) occurs and the factors a court may consider in determining fair market value at that time. For example, if death was imminent due to a prolonged illness, that fact may be relevant in determining fair market value of property at death.

Valuation problems may also occur if the shares are subject to a buy-sell agreement. Specifically, the pre-determined purchase price selected by the parties may not reflect current market values. The problem that may arise, if the agreed price is used to determine proceeds for purposes of the buy-sell agreement, is that the amount so selected, may not equal fair market value for purposes of subsection 70(5). The CRA's views in resolving this issue are summarized as follows. The price in a buy-sell agreement between arm's length parties is generally accepted. However, where the deceased and the surviving party to a buy-sell agreement did not deal at arm's length, it is a question of fact whether the fair market value for the purpose of subsection 70(5) will be determined with reference to the agreement. Paragraph 69(1)(b) may apply to change the stated value of the buy-sell agreement to reflect fair market value in a non-arm's length transaction and the deceased may be deemed for tax purposes to have received a different amount than actually received. For further details, see Interpretation Bulletin 140-R3, April 14, 1989, "Buy-sell Agreements".

ii. Property Owned by the Deceased

Since the provisions in subsection 70(5) apply to any capital property owned by the deceased immediately prior to death, a careful review of the deceased's assets will be necessary. Consider the effect of subsection 70(5) in relation to property jointly owned by the deceased, and property held as a life estate.[7] Such property rights are also subject to the deemed disposition rules. For example, the deceased's interest in a house held jointly with his or her spouse is subject to a deemed disposition on death under subsection 70(5) notwithstanding that the house automatically transfers to the spouse by operation of law. In the CRA's view the joint tenancy could have been severed immediately prior to death. The disposition is therefore of a notional interest held by a tenant in common. If the house is a principal residence, the gain may qualify for the principle residence exemption detailed below.

[7] Paragraph 43.1(2)(a).

iii. Transfers as a Consequence of Death

As discussed below, relief from the deemed disposition provisions in subsection 70(5) is provided to the deceased if property is transferred to a spouse, common-law partner, or conjugal trust, as well as to children in the case of qualified farm or fishing property. This relief is predicated by the requirement that the property be transferred to the intended beneficiary in accordance with subsection 248(8). In summary, this provision requires that the property be transferred by will or other testamentary instrument, on intestacy or as the result of a disclaimer, or release or surrender. Subsection 248(8) is discussed in more detail below.

B. Relieving Provisions for Capital Property

The deemed disposition rules applicable on death may give rise to tax liability. If the property continues to be used by the deceased's family, the tax liability is made more onerous if the estate does not have sufficient liquidity to discharge that liability without sale of the property. Fortunately, the Act contains a number of relieving provisions (rollovers) with respect to capital property, which apply if the property is transferred either to the spouse or common-law partner of the deceased, to a trust for the benefit of either, or in limited circumstances to the deceased’s children as a consequence of death.

Where a rollover applies, the deceased is deemed to have disposed of his or her non-depreciable capital property immediately prior to death for proceeds of disposition equal to the adjusted cost base of the property and, in the case of depreciable property, for proceeds equal to its undepreciated capital cost. As a result, the deceased will not suffer capital gains or recapture by virtue of subsection 70(5). However, any tax liability that would otherwise have arisen is not forgiven; it is merely deferred until the transferee subsequently disposes of the property. Each of these relieving provisions is discussed below.

The Act provides for a rollover of both depreciable and non-depreciable capital property transferred to the deceased's spouse or common-law partner or to a trust for either. There are additional rollovers for farm or fishing property, shares of a family farm corporation, or interest in a family farm or fishing partnership or corporation transferred to the deceased's spouse, common-law partner, a trust for either, or to children of the deceased.

i. Property Transferred to, or in Trust, for a Spouse or Common-Law Partner

a. To a Spouse or Common-Law Partner

Capital property transferred to a deceased's spouse or common-law partner as a consequence of death is not subject to the deeming provisions in subsection 70(5) if the following conditions are met:

- the deceased and his or her spouse or common-law partner are resident in Canada immediately before the death of the deceased[8]; and

- the property vests indefeasibly in the spouse or common-law partner within 36 months of the deceased's death and the fact of this vesting is established within 36 months of the death or such longer period as the Minister determines reasonable in the circumstances upon written application for any extension made within the period.

If these conditions are met, the property is automatically deemed by subsection 70(6) to roll to the beneficiary at its tax cost unless the personal representative elects under subsection 70(6.2) to have the deemed disposition in subsection 70(5) apply. Such an election might be made, for example, to create capital losses or terminal losses in the deceased’s terminal year or to maximize otherwise available capital losses against current capital gains.

There are four ways in which property can be rolled "as a consequence of death" to a

[8] The Third Protocol to the Canada-U.S. Tax Treaty permits a rollover to a spouse or common-law partner where the deceased was resident in the U.S. immediately before death.

spouse or common-law partner:

1. by will or other testamentary instrument [paragraph 248(8)(a)];

2. on an intestacy [paragraph 248(8)(a)];

3. by disclaimer, or release or surrender of a beneficiary under a will or on an intestacy [paragraph 248(8)(b)]; and

4. as a consequence of provincial laws relating to spouse's or common-law partner's interest in property [subsections 248(9.1) and (23.1)].

Proof that vesting has occurred must be established within 36 months of the date of death or such longer period as the Minister considers reasonable. Therefore, delay in taking steps to establish vesting may exclude the application of the rollover. Although what constitutes a reasonable period should be a question of fact, the Act leaves the matter to be determined by the Minister if written application is made within 36 months of the death. Presumably a delay in establishing vesting owing to litigation or a settlement of claims would be considered reasonable. The only real guidance on this question is *Hillis et al. v. The Queen,*[9] which precluded a rollover due to an unreasonable delay in administering an estate. As a result of that decision, the period for establishing vesting was increased from 15 to 36 months. Perhaps coincidentally, this closely matches the actual administration period in the *Hillis* case.

The *Hillis* decision is probably also the reason for the introduction of subsection 248(23.1) that now specifically recognizes the effect of provincial legislation in determining the timing of the transfer to a spouse or common-law partner. A transfer that results from a Family Relief application, for example, may be effective as of the date of death. The transfer is deemed to occur as a consequence of death if made to the spouse or common-law

[9] *Hillis et al. v The Queen* 83 DTC 5365 (FCA)

partner, or immediately before the time that is immediately before the death if the transfer is made by the spouse or common-law partner to the deceased's estate. In either case a rollover occurs notwithstanding that a provincial court order is made outside the 36 month period.

C. Vested Indefeasibly

Subsection 70(6) requires that the property "vest indefeasibly" in the spouse or common-law partner to achieve a rollover. Subsection 70(9) imposes a similar requirement for transfers of qualifying farm or fishing property to a child. Not surprisingly, a number of decisions have addressed the issue of when property vests indefeasibly for these purposes. One of the most important of these decisions is *Boger Estate v. MNR*[10].

In *Boger,* the taxpayer, a farmer, died testate on March 10, 1979. A life estate in the home quarter was left to his widow and the remaining farm assets (seven quarter sections of land, farm equipment, livestock and grain) were left to his four daughters. The widow brought a *Family Relief Act* Application. At issue was whether the farm property vested indefeasibly in the children within the required time for purposes of the farm rollover in subsection 70(9), notwithstanding the outstanding *Family Relief Act* application. The Federal Court held that the property interest was granted under the will and had vested. Further, a vested interest is defeasible only if it is subject to a condition subsequent contained in the grant creating the interest. *The Family Relief Act* application did not delay vesting, but a portion of the interest transferred to the children was retroactively affected by the court order. In summary, according to *Boger*, the test to determine whether an interest is vested indefeasibly is whether it is "subject to a condition subsequent or a determinable limitation set out in the grant."

A number of decisions have also examined the issue of vesting in the context of shareholder agreements. In *W.R. Parkes v. MNR*[11], and *Greenwood Estate v. Canada,*[12]

[10] *Boger Estate v MNR*, [1993] 2 CTC 81 (FCA)

[11] *W.R. Parkes v MNR,* [1986] 1 CTC 2262

the court held that shares subject to a mandatory buy-sell agreement did not vest indefeasibly for purposes of the spousal rollover. In contrast, in *Van Son Estate v. Canada*[13], a right of first refusal in an agreement, which imposed an obligation to buy on the survivor but no obligation to sell on the beneficiary spouse, resulted in a finding that the shares had vested indefeasibly. The CRA's current position is that shares subject to a compulsory buy-sell agreement will not qualify for subsection 70(6) rollover treatment. However, the CRA will accept shotgun and right of first refusal clauses and allow for rollover treatment in these situations.

Certain limitations also apply in determining whether vesting has occurred. For example, paragraph 248(9.2)(a) provides that property will be deemed not to have vested indefeasibly in a trust where the taxpayer's spouse or common-law partner is a beneficiary if the trust is created by the will of the taxpayer, unless the property vested indefeasibly in the trust before the death of the spouse or common-law partner. The apparent purpose of this provision is to ensure that a rollover of property on the death of an individual will occur only in circumstances where the deferred gains will be recognized on the death of the beneficiary spouse or common-law partner. Similarly, paragraph 248(9.2)(b) provides that property will be deemed not to have vested indefeasibly in an individual (other than a trust), unless the property vested indefeasibly in the individual before their death.

i. To a Trust for a Spouse or Common-Law Partner (Conjugal Trust)

Capital property that is transferred to a testamentary trust for a spouse or common-law partner also receives rollover treatment if the property vests indefeasibly in the trust within the stipulated 36 month period and the following requirements are met:

- the property is property of a taxpayer who was resident in Canada immediately before his or her death;

- on or after the taxpayer's death, and as a consequence thereof, the property is

[12] *Greenwood Estate v Canada,* [1994] 1 CTC 310 (FCA)

transferred or distributed to the trust;

- the trust is created by the taxpayer's will;

- the trust is resident in Canada immediately after the time the property vests indefeasibly in the trust;

- the spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death;

- no person except the spouse or common-law partner may, before the death of the spouse or common-law partner, receive or otherwise obtain the use of, any income or capital of the trust.

Perhaps the two most commonly offended rules in creating a conjugal trust relate to the allowed treatment of income and capital of the trust. The surviving spouse or common-law partner must be entitled to all of the income of the trust and no person except the spouse or common-law partner may receive or otherwise obtain the use of any of the trust income or capital. An encroachment on capital for the benefit of the spouse or common-law partner is entirely acceptable; however, the mere possibility of anyone else receiving a "benefit" from the trust assets during that lifetime of the spouse or common-law partner would appear to prevent the rollover. Two obvious questions emerge from these statutory conditions. First, what precisely is the meaning of "entitled to all of the income" as described in subparagraph 70(6)(b)(i)? Second, under what circumstances will another person be considered to receive or otherwise obtain the use of any income or capital of the trust?

ii. Entitled to All of the Income

Although subsection 70(6) requires that the spouse or common-law partner be "entitled to

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[13] *Van Son Estate v. Canada*, [1990] 1 CTC 182 (FCTD)].

all of the income" of the trust if a rollover is to be achieved, there are a number of qualifications to this general rule.

First, in determining whether the recipient is entitled to receive all of the income of the trust arising during his or her lifetime, subsection 108(3) of the Act provides that, subject to specific exceptions, the income of a trust is calculated without reference to the provisions of the Act. Calculation of income amounts would, therefore, presumably conform to the requirements of equity and trust law. It follows that income computed using these rules would produce a different result than would income calculated for tax purposes. Most obviously, stock dividends and taxable capital gains may give rise to tax liability as a result of income generated but would not be income to which the spouse or common-law partner must be entitled for purposes of subsection 70(6). In addition, one of the specific exceptions listed in computing the income of a trust for this purpose is tax-free capital dividends.

Second, according to subsection 108(4), a trust is not disqualified from being a conjugal trust even though it is charged with payment of income tax as if it were a separate individual taxpayer. Similarly, the trust will remain a conjugal trust notwithstanding a clear obligation imposed on the trust to pay any estate, legacy, and succession or inheritance duty payable as a consequence of the testator's death in respect of any property of the trust or any income or capital interest in the trust.

The CRA also provides two administrative concessions when determining whether the spouse or common-law partner is entitled to receive all of the trust income. First, if the will of the decedent provides for the establishment of the trust from the residual assets of the estate, the fact that income derived from the assets prior to the vesting in the trust is used to pay specific bequests or other testamentary debts will not preclude the trust from qualifying for a rollover. Second, the CRA applies the doctrine of constructive receipt in interpreting the requirement that the spouse or common-law partner must be entitled to receive all of the income of the trust that arises before her/his death. As a result, a provision in a will for the payment of any income of the trust to a person other than the spouse or common-law partner, on the condition that it be used solely for the benefit of the spouse or common-law partner, will not disqualify an otherwise qualifying conjugal trust.

iii. Transfers as a Consequence of Death

A number of the rollover provisions, including those applicable on transfers to a spouse, common-law partner or conjugal trust and transfers of farm property, require that the transfer occur "as a consequence of the death of the taxpayer." This will include property received from an estate in satisfaction of the spouse’s entitlement under provincial legislation such as the Ontario *Family Law Act*.

Paragraph 248(8)(b) provides that, for the purposes of the Act, a transfer, distribution or acquisition of property as a consequence of a disclaimer, or release or surrender by a person who was a beneficiary under a will or on the intestacy of the deceased, or his/her spouse or common-law partner, is considered to be a transfer, distribution or acquisition of the property as a consequence of death. Thus, if an effective disclaimer is made, property of the deceased acquired by Beneficiary B as a result of a disclaimer by Beneficiary A will be property transferred or distributed to Beneficiary B as a consequence of the death of the deceased. Furthermore, for a valid disclaimer, no benefit should have been obtained by Beneficiary A. The time limit, according to subsection 248(9), for a disclaimer or, release or surrender is 36 months after the death of the taxpayer or such longer period as is permitted upon written application to the Minister.

Paragraph 248(8)(c) goes on to provide that a release or surrender by a beneficiary with respect to any property that was property of a taxpayer immediately before his/her death will not be considered a disposition of the property by the beneficiary, provided no benefit has been obtained by the beneficiary. The phrase "release or surrender" was substituted for the term "renunciation" in the definition of occurrences as a consequence of death. The CRA has stated that the new words are used because they have "a clearer common law meaning" than the term "renunciation." Again, a valid release or surrender must occur within 36 months of the death of the taxpayer or such longer period, as the Minister considers reasonable.

Whether a disclaimer of a non-qualifying interest in a conjugal trust will result in a rollover is not apparent in the Act. Notwithstanding that a disclaimer is effective to cause a transfer to occur "as a consequence of death," paragraph 70(6)(b) imposes the further requirement that a trust for a spouse or common-law partner must be created by the deceased's will.

Subsection 248(9.1) provides that a trust will be considered to have been created by a taxpayer's will if it was created "under the terms of the taxpayer's will" or "or by an order of the court in relation to the taxpayer’s estate . . . made pursuant to any law of a province providing for the relief or support of dependants." The legislation is silent about whether a trust that is compliant as a result of a disclaimer will qualify for a rollover. Notwithstanding, the CRA's current views expressed in IT-305R4, October 30, 1996, “Testamentary Spouse Trusts,” suggest that a disclaimer by a beneficiary of an income or capital interest in an otherwise non-qualifying trust may result in rollover treatment if the disclaimer results in a purification of the trust.

iv. Tainted Trusts

A conjugal trust must entitle the deceased's spouse or common-law partner to receive all of the income of the trust that arises during his or her lifetime and must preclude any other person from receiving income or capital of the trust during that period. A testamentary instrument that directs the personal representative to pay the debts and discharge the liabilities of the testator, other than those specifically referred to in subsection 108(4), would, according to the CRA, taint a qualifying conjugal trust thus preventing a rollover.

Fortunately, relieving provisions were introduced in the form of subsections 70(7) and (8) to cure a tainted trust. The general scheme of the relieving provisions is to permit the trust to qualify for the rollover if the personal representative elects and lists properties of the deceased at least equal to the value of the debts. These listed properties are then deemed to have been disposed of immediately prior to death for proceeds equal to their fair market value. For example, if the testamentary debts equaled $500, the personal representative could list shares in the trust with a cost base of $200 and a fair market value of $500. The result would be a deemed disposition of the shares at their fair market value of $500, instead of a deemed disposition of all the assets in the trust. As property in excess of the amount of the debts may have to be listed, the Act permits the personal representative to elect to realize only part of the capital gain or capital loss on one designated property in order to untaint the trust. This option may provide some additional flexibility in the terminal year than otherwise would be available under subsection 70(6.2). For example, one could intentionally taint the trust to then have the option of cleaning up the trust through the relieving provisions in subsections 70(7) and (8).This may provide additional flexibility to the legal representative in dealing with the deceased's assets. The election under subsection 70(6.2) to exclude the conjugal rollover provisions, does not include the option of realizing only part of a gain or loss on transferred property.

The mechanics of the rules to untaint the trust are set out in IT-305R4 and an example from this bulletin is provided below.

Testamentary debts

Income tax owing by the deceased	*$10,000*	
Business debt of the deceased	*25,000*	
Mortgage on apartment building	*80,000*	
Mortgage on land	*10,000*	
Testamentary and funeral expenses	*1,000*	*$126,000*

To determine non-qualifying debts, deduct:

Mortgage on apartment building	*$80,000*	
Mortgage on land	*10,000*	*$90,000*

Non-qualifying debts *$36,000*

The executor then lists properties of the tainted spouse trust having a total fair market value immediately after death at least equal to these non-qualifying debts. For this purpose, paragraph 70(8)(a) defines the fair market value of a property as the amount, if any, by which its fair market value otherwise determined exceeds the amount of any debt secured by a mortgage on the property.

Listed property:

Shares -Fair market value	*$9,000*
Land - Fair market value	*41,000*

Less: Mortgage on the land	10,000	
Net fair market value of the land	31,000	
Net fair market value of list property		$40,000

Capital gain or loss:

Shares - Fair market value		$ 9,000
Adjusted cost base to the deceased		6,000
Capital gain	$ 3,000	
Land - Fair market value		$41,000
Adjusted cost base to the deceased		30,000
Capital gain	$11,000	

The deemed disposition rules in subsection 70(5) apply to the capital properties so listed and, in this example, the total capital gain before any reduction under subparagraph 70(7)(b)(iii) (see 21 below) is $14,000 ($3,000 + $11,000).

21. When the fair market value of all the properties listed exceeds the total non-qualifying debts (this excess is referred to as the "listed value excess") and the taxpayer's legal representative designates one capital property so listed (other than money and depreciable property) in the taxpayer's return, the capital gain or loss on that property (from the deemed disposition under subsection 70(5)) will be reduced as a result of the formula in subparagraph 70(7)(b)(iii). Under subparagraph 70(7)(b)(iii), the capital gain or loss on the property is:

$$\text{Capital gain or loss otherwise determined} \times \frac{\text{Fair market value of the one property minus the listed value excess}}{\text{Fair market value of the one property immediately after death}}$$

22. The following examples illustrate the application of the rule in subparagraph 70(7)(b)(iii).

Example 1:

The listed value excess in the example in 20 above is $4,000 ($40,000 - $36,000). In that example, assume that the legal representative has designated the shares that have been listed. Pursuant to subparagraph 70(7)(b)(iii), the capital gain on the shares is calculated as follows:

$$\$3,000 \times \frac{(\$9,000 - \$4,000)}{\$9,000} = \$1,667$$

Therefore, the total capital gain to be included in the deceased's income is $12,667 ($1,667 + $11,000). The adjusted cost base of the two properties to the spouse trust is: land $41,000 (by virtue of paragraph 70(5)(b)) and shares $7,667 ($6,000 + $1,667, by virtue of clause 70(7)(b)(iv)(A)).

Example 2:

Same as example 1 above; however, assume that the adjusted cost base of the shares is $16,000 and that, consequently, the shares otherwise result in a capital loss of $7,000 ($9,000 - $16,000). The capital loss calculated in accordance with subparagraph 70(7)(b)(iii) is:

$$\$7{,}000 \times \frac{(\$9{,}000 - \$4{,}000)}{\$9{,}000} = \$3{,}889$$

Therefore, the net capital gain from the land and shares is \$7,111 (\$11,000 - \$3,889). The adjusted cost base of the two properties to the spouse trust is: land \$41,000 (by virtue of paragraph 70(5)(b)) and shares \$12,111 (\$16,000 - \$3,889, by virtue of clause 70(7)(b)(iv)(B)).

v. Residence of Trusts

Generally, to qualify for a rollover to a conjugal trust for a spouse or common-law partner, the capital property must be transferred to "a trust ... that was resident in Canada". The Act contains no specific rule for determining the residence of a trust. Subsection 104(1) does, however, provide that a reference to a trust shall be read as a reference to "the trustee or the executor, administrator, heir or other legal representative having ownership or control of the trust property" unless the context otherwise requires. The residence of the majority of the trustees has traditionally been the determining factor in establishing the residence of the trust. The *Thibodeau*[14] decision indicates that residence is a question of fact but is normally where the management and control of the trust reside. Recently, however, the Tax Court of Canada in the *Garron*[15] decision has proposed the management and control test for determining trust residency. The *Garron* decision is currently under appeal to the Federal Court of Appeal thus leaving the law in this area in a state of flux.

A major exception to the rule that a spouse, common-law partner, or conjugal trust must be resident in Canada for rollover treatment occurs by virtue of a 1996 amendment to the Canada-U.S. Tax Treaty ("the Treaty"). Article XXIX B(5) (1980), of the Treaty provides that if an individual was a resident of the United States immediately before that individual's death, both the individual and the individual's spouse or common-law partner are deemed to have been resident in Canada immediately before the individual's death for the purpose of subsection 70(6). If certain additional conditions are met and the Canadian competent authority agrees, a trust for that spouse or common-law partner will also be treated as being resident in Canada.

[14] *Thibodeau Family Trust v R*, [1978] C.T.C. 539

a. Transfers of Farm or Fishing Property

Certain farm and fishing assets receive special treatment under the Act pursuant to both the deemed disposition rules and the provisions permitting the lifetime capital gains deduction.

Land and depreciable property of a prescribed class that is used in the business of farming or fishing, may be transferred to a child of the deceased on a rollover basis. Further, dispositions of qualified farm or fishing property are eligible for the $750,000 lifetime capital gains deduction. Finally, unlike the rules that apply to trusts for spouses and common-law partners, the deceased's personal representative may elect to realize all or any part of an accrued capital gain or recaptured depreciation on farm or fishing property transferred to a child. For purposes of this provision, the meaning of child extends to include grandchildren and great grandchildren of the taxpayer. This provision increases the flexibility available to tax planners.

The rollover of farm or fishing property on death to a child of the deceased taxpayer under subsection 70(9) will occur if the following conditions are met:

- the child was resident in Canada immediately before the death of the deceased;

- the property is situated in Canada;

before the taxpayer's death, the property was used principally in the business of farming or fishing in which the taxpayer, the taxpayer’s spouse or common-law partner or any of the taxpayer’s children was actively engaged on a regular and continuous basis;[16]

- the property was transferred or distributed to the child as a consequence of the taxpayer's death; and

[15] 2009 TCC 450.
[16] CRA Views 2008-0303761E5 says that if a person owns multiple farms and works on them it does not preclude a finding that this person works on each farm on a regular and continuous basis.

- it can be shown within 36 months after the taxpayer's death, or such longer period, as the Minister considers reasonable in the circumstances following written application for such extension, that the property vested indefeasibly in the child.

If these conditions are met, the deceased is deemed to have disposed of the property for proceeds equal to, in the case of depreciable property, the lessor of the capital cost and the cost amount to the taxpayer of the property immediately before the taxpayer's death, and, in the case of the land, its adjusted cost base. The requirement that the property to be used in the business of farming or fishing does not require that it be so used <u>immediately prior</u> to the death of the taxpayer.[17]According to the CRA, “principally” is generally considered to be 50% of the time or greater.

A rollover is also available pursuant to subsection 70(9.1) if the property is transferred to a trust for a spouse or common-law partner by will or during the deceased's lifetime, and on the death of that spouse or common-law partner, vests indefeasibly in a child of the deceased who is resident in Canada immediately before the death of the surviving spouse or common-law partner. For this double rollover to occur, the property must have been used in the business of farming or fishing immediately before the death of the spouse or common-law partner. The intervening conjugal trust will make it immaterial whether the property was used in this manner during the lifetime of the deceased. As is the case for farm or fishing property transferred directly to a child under subsection 70(9), the trust may elect to realize all or any part of an accrued gain on the farming or fishing property transferred to a child after the death of the spouse or common-law partner. This rollover provides important planning opportunities as it allows the deceased to use his or her capital gains deduction on death, as well as allowing the spouse or common-law partner to use their capital gains deduction before property is transferred to the child. Subsection 70(9.2) allows shares of the capital stock of a family farm or fishing corporation of the taxpayer and interests in a family farm or fishing partnership to be transferred to a child of the taxpayer without realization of any or all of the accrued capital gains or capital losses. A family farm or fishing corporation or partnership is defined in subsection 70(10) to mean a corporation or partnership in which all or substantially all of the property was used principally in the course of carrying on the business of farming or fishing in Canada in which the person or a spouse, common-law partner, child or parent of the person was actively engaged on a regular and continuous basis. Principally is generally considered by the CRA to mean more than 50%. Shares of the capital stock of a corporation will also meet the definition if all or substantially all of the corporate assets consist of shares of a corporation qualifying as a family farm or fishing corporation and/or family farm or fishing property. The CRA considers the phrase "all or substantially all" to mean more than 90%. Provision is also made for a rollover, if under the terms of the trust document, such shares or interests are first transferred to a trust for a spouse or common-law partner and later distributed to a child of the testator upon the death of the surviving spouse or common-law partner [subsection 70(9.3)].

If farming or fishing property or shares or interests of a family farm or fishing corporation or partnership were transferred to a child by an inter vivos or testamentary transfer, and, as a consequence of the death of the child, the property is transferred to a surviving parent, the deceased child’s legal representative can elect that the transfer to the parent occur on a rollover basis [subsection 70(9.6)].

Recall that the rollover under subsection 70(9) is available only if the farm or fishing property is transferred or distributed to the child "as a consequence of the death" of the deceased. Prior to the introduction of subsection 248(8), there was concern that the rollover would be lost if a child was required to provide consideration to the deceased's estate in satisfaction of the terms of the deceased's will as a condition to acquiring the farm or fishing property. For example, it was not uncommon, in intergenerational transfers of this type of property, for the deceased to leave the family farm or fishing business to one child provided that the child pays sufficient consideration to the estate to fund bequests to other beneficiaries. Paragraph 248(8)(a) is said to have been added to ensure that a rollover is available in such circumstances. The CRA's position on intergenerational transfers of farm property is set out in Interpretation Bulletin IT-349R3, November 7, 1996,

[17] CRA Views, Interpretation External 2007-0240321E5, October 9, 2007.

"Intergenerational Transfers of Farm Property on Death".

b. Principal Residence

On the death of a taxpayer, the taxpayer's principal residence, like the taxpayer's other capital properties, is deemed to have been disposed of. However, a principal residence[18] is given special treatment under the capital gains provisions of the Act.

Any taxable capital gain arising on the disposition of the property is reduced according to a formula measuring the number of years that the property was the taxpayer's principal residence in the period during which the taxpayer was its owner. To achieve this reduction, the property must be designated as a principal residence in the year it is disposed of and no person can designate more than one principal residence for any year.

If the principal residence was part of a farm, the taxpayer has two options. He or she may elect to notionally sever the principal residence from the farming property and calculate the gain or loss on each property separately. Alternatively, the taxpayer may calculate the gain on the farming property as if it did not include a principal residence, and then deduct $1,000 plus $1,000 for every year in which the taxpayer was resident in Canada and the property contained the taxpayer's principal residence [paragraph 40(2)(c)].

The amount of the deemed proceeds on death will depend upon whether subsection 70(5) or 70(6) is applicable. If subsection 70(5) applies, any gain is computed in the same way as if the property had been disposed of during the taxpayer's life. If subsection 70(6) applies, the spouse, common-law partner or conjugal trust will acquire the property at a cost equal to its adjusted cost base and no gain will be realized. In order to ensure that no gain is attributed to a period in which the property was the principal residence of the deceased arises when the spouse, common-law partner or the conjugal trust subsequently disposes

[18] The term "principal residence" is defined in section 54 and, in general terms, is a housing unit which is owned by the taxpayer, alone or jointly, and ordinarily inhabited in the year by the taxpayer, the taxpayer's spouse or former spouse or dependant child.

of it, the spouse or common-law partner or conjugal trust is deemed to have owned the property for each year in which it was owned by the deceased, to have occupied it as a principal residence for each year in which it was the deceased's principal residence and, in the case of a conjugal trust, to have been resident in Canada in each year in which the deceased was resident in Canada [subsection 40(4)]. For further information see Interpretation Bulletin IT-120R6, July 17, 2003, “Principal Residence”.

A trust that is a personal trust may also generally claim a property as a principal residence for a taxation year if, in that year, an individual "beneficially interested" in the trust ordinarily inhabits the property or has a spouse, common-law partner, former spouse or common-law partner or child who ordinarily inhabits it. To qualify for the exemption, the principal residence must be designated by the trust in prescribed form and manner The specified beneficiary must be listed in this designation by the trust for its taxation year and is treated as having personally designated the property as a principal residence for the calendar year ending in that year. Not more than one principal residence may be claimed, either directly or through a trust, by a family unit for a taxation year.

2. LAND INVENTORY

Land that is the inventory of a business conducted by the deceased is subject to a deemed disposition for proceeds equal to its fair market value immediately prior to the deceased's death [paragraph 70(5.2)(c)]. The excess of the proceeds over the cost of the land is included in computing the deceased’s income. Paragraph 70(5.2)(d) provides an exception where the deceased was a Canadian resident taxpayer immediately before death and the land comprising the inventory vests within 36 months of the death in the deceased’s spouse or common-law partner or a conjugal trust. In that case a rollover occurs and the deceased’s proceeds of disposition and the cost of acquisition by the recipient are deemed to be an amount equal to the cost amount of the land to the deceased immediately before death. The tax consequences if the recipient subsequently disposes of the property will depend on whether the property was held by the taxpayer after the transfer on account of income or capital.

3. RESOURCE PROPERTIES

Subject to the usual exceptions for property transferred to a spouse or common-law partner or a conjugal trust, Canadian and foreign resource properties are deemed to have been disposed of immediately prior to the deceased's death for proceeds equal to their fair market value [paragraph 70(5.2)(a)]. The acquisition cost to the taxpayer, who receives the property on the death of an individual is also considered to be equal to its fair market value. If the property vests indefeasibly in a spouse or common-law partner or a conjugal trust within 36 months of the death of the deceased, a rollover occurs. The personal representative may also elect, within limits, to immediately realize some or all of the deferred income [paragraph 70(5.2)(b)]. The recipient of the deceased's resource properties acquires the assets at a cost equal to the amount included in the deceased's income, or the amount deducted in computing the deceased's cumulative Canadian development expense or cumulative Canadian oil and gas property expense by virtue of the disposition. Any subsequent disposition by the recipient is governed by the general provisions of the Act applicable to dispositions of resource properties of a taxpayer. [See Interpretation Bulletin IT-125R4, April 21, 1995, "Dispositions of Resource Properties".]

4. ELIGIBLE CAPITAL PROPERTY

Eligible capital property includes non-depreciable intangibles such as goodwill. Generally, if a taxpayer carried on business prior to death, no amount is included in income in respect of these assets as a consequence of death. The person who acquires the deceased’s eligible capital property is deemed to have acquired it at a cost equal to the deceased’s proceeds. If the recipient continues to carry on the business of the deceased, he or she in effect acquires the cumulative eligible capital of the deceased and may claim an eligible capital expenditure deduction in subsequent years with respect to it. If the recipient does not continue the business, the eligible capital property will become his or her capital property and is acquired at a cost equal to four-thirds of the deceased's cumulative eligible capital. In effect a rollover occurs. As a result, any excess in the value of the property over that cost will be a capital gain of the recipient when he or she disposes of the property.

[See IT-313R2, April 21, 1995, “Eligible Capital Property - Rules Where a Taxpayer has Ceased Carrying on Business or Has Died”.]

5. PARTNERSHIP RIGHTS

If the deceased was an active or a retired partner of a firm, his/her rights with respect to the partnership may give rise to capital gains or income under a number of the previous headings. The detailed rules for the taxation of partnership income are outside the scope of this work, but some reference to general principles is necessary for the purpose of explaining the treatment of a partner's rights in his/her terminal year.

Unlike a corporation or a trust, a partnership is not a taxpayer, nor is the term partnership defined in the Act. A partnership is governed by provincial law and is generally defined as a legal relationship existing between two or more persons carrying on a business in common for the purpose of profit. This is a question of fact. Each year, the income of a partnership is allocated and taxed to its members according to their respective shares under the partnership agreement [subsection 96(1)]. This does not mean that the partnership relationship is ignored for tax purposes. Before amounts of income can be allocated to the partners, income must first be computed at the partnership level as if the partnership were a separate person resident in Canada. It follows that most of the deductions, such as capital cost allowance (CCA), available in computing income, will be taken at the partnership level and not by the partners individually. When income is allocated to members of the partnership, it retains its identity as income from a particular source. For example, capital gains that are subject to preferential treatment retain their character and flow out to the individual partners as capital gains. If the partnership has an excess of allowable capital losses over taxable capital gains, or other losses from a particular source, these are also allocated among the partners according to their shares under the partnership agreement.

Amounts of income so allocated to a partner are included in his/her income for the calendar year in which the partnership's fiscal year ends, regardless of whether such amounts are actually received by the individual partners [paragraph 96(1)(f)].

A partner's interest in the partnership is capital property and a capital gain or loss may arise when this property is disposed of. If the partner's interest was acquired after 1971, the adjusted cost base of the interest is the cost of acquisition plus or minus any adjustments required by section 53. Under paragraph 53(1)(e), amounts to be added to the cost will include contributions to the capital of the partnership, the partner's share in the profits or capital gains of the partnership for each of the partnership's fiscal years and the excess of life insurance proceeds received by the partnership over the adjusted cost basis under the policy. Deductions available for the purpose of computing the adjusted cost base include the partner's share of the partnership's losses for each of its fiscal periods, the amount of partnership's profits distributed to that partner and any distribution of, or in satisfaction of his/her share in, the partnership capital.

It follows that the adjusted cost base of a partnership interest will fluctuate as profits are received by the partnership and are subsequently withdrawn by the partners. For this reason, the general rule that capital property cannot have a negative adjusted cost base is not applicable to partnership interests, so long as the partner retains the interest and the partnership continues to exist. Thus, where the adjusted cost base is negative, it will not give rise to a capital gain until there has been a disposition of the partnership interest [paragraph 40(3)(a)].

A. Death of an Active Partner

The deceased's share of the profits of the partnership from the end of the last fiscal year of the partnership to the date of death are a right or thing whose value must be included in the terminal return unless a separate return is filed under subsection 70(2) unless the right to receive the profits is transferred to a beneficiary under subsection 70(3).

As the deceased's interest in the partnership is capital property, it will also be subject to a deemed disposition immediately prior to his/her death [subsection 70(5)]. The interest will not be acquired by the estate as an interest in the partnership but, rather, as a right to receive partnership property [paragraph 100(3)(a)]; therefore, the special rules that apply to a disposition of a partnership interest and to the computation of its adjusted cost base will have no application to the right to receive partnership property by the estate. Amounts received in satisfaction of the right are deducted from its adjusted cost base and a capital gain will arise if and when the adjusted cost base is reduced below zero. This would most commonly occur where the successor is a spouse or a spouse trust. Alternatively, a capital loss will be realized if the amount paid to the estate, or to a beneficiary of the estate, in satisfaction of the right to receive partnership property, was less than the fair market value of the partnership interest immediately before the death of the partner. The fair market value of the deceased's partnership interest immediately before death will reflect the value of his/her share of profits for the terminal period, therefore the value of the amounts that are rights and things on the death of the deceased is added to the adjusted cost base of the partnership interest.

If at the time of his/her death the deceased had rights with respect to work in progress, its value may be treated as income of the deceased partner, income of the recipient, or capital. As a general rule, the value of the work in progress will be included in the fair market value of the deceased’s partnership interest and will therefore increase its fair market value. As a result, an amount that would have been income if the partner had lived to receive it will give rise to a capital gain on the deemed disposition of his/her interest immediately prior to death, or on a subsequent disposition by a spouse or by a spouse trust. This conversion of income to capital gain will be achieved at the expense of the continuing partners who must include in income the profits, which are recognized when the work in progress is completed, without the benefit of a deduction for payments made to the estate in satisfaction of the deceased's rights. If, however, the partnership agreement provides that the estate or a beneficiary will be entitled to receive a share of the partnership income as compensation for the deceased's work in progress, the provisions of subsection 96(1.1) will apply and the estate or beneficiary will be treated as a member of the partnership with respect to that income. As a consequence the work in progress will be taxed as income in the hands of the estate or the beneficiary and will not be income of the continuing partners or of the deceased for his/her terminal year.

In the above discussion, it has been assumed that the partnership would not be dissolved upon the death of the partner. The general rule, under partnership legislation, in most common law jurisdictions is that, unless the partners have agreed to the contrary, the death of a partner will cause the partnership to be dissolved. If this occurs, income or capital gains may be realized on dispositions of the partnership property to the former partners [subsections 98(1) and (2)]. If, however, the partnership property is transferred to a new Canadian partnership in which the only members were members of the predecessor partnership, the new partnership is deemed to be a continuation of the old partnership [subsection 98(6)] and a rollover of the partnership assets results. If there are only two members of the partnership, the death of one partner will lead to its automatic dissolution unless the partners previously agreed that the personal representatives of the deceased partner or some other person is to be admitted to the partnership when the death of one partner occurs. In the absence of such an agreement, a rollover may be available to the surviving partner with respect to partnership property distributed to him or her, if the survivor carries on the business of the partnership and continues to use the particular property in the business [subsection 98(5)].

B. Death of a Retired Partner

When a partner disposes of his/her interest on retirement, a capital gain or a capital loss may be realized according to the general rules of computing capital gains and losses. In many cases, however, it will neither be convenient nor desirable for the partnership, or the remaining partners, to pay a retiring partner the full value of his/her residual interest in the partnership immediately on retirement. Where the partnership is to discharge the interest by payments to be spread over a period, subsection 98.1(1) provides that the partnership interest will be deemed not to have been disposed of until all the payments have been received. In consequence, no question of any reserve under subparagraph 40(1)(a)(iii) will arise and no capital loss will be realized until all the payments have been received. In this situation, however, a capital gain will be realized if at any time the payments received by the partner in satisfaction of his/her residual interest reduce its adjusted cost base below zero. Subsection 98.1(1) applies only if the retired partner is to receive property from the partnership in satisfaction of his/her partnership interest. If the retiring partner had entered into a buy-sell agreement with the other partners, the sale of his/her interest would be subject to the normal rules, which govern dispositions of capital property.

Partnership agreements will often provide for a retired partner to continue to receive a share of income from the partnership. This may reflect his/her share of work in progress at the date of retirement and it may also be in part a retiring allowance, which recognizes his/her service to the partnership and his/her contribution to its growth. In such a case subsection 96(1.1) will apply and will deem the retired partner to be a member of the partnership for the purpose of computing his/her income and that of the other partners. It follows that the share of income that is paid to the retired partner will not be allocated or taxed to the other members of the partnership. If, under the agreement, the income is to be paid to the former partner's spouse, common-law partnership, estate or heirs, it is the recipient who will be deemed to be a member of the partnership.

The right to receive income under an agreement of the kind described in subsection 96(1.1) is treated quite independently of any residual interest in the partnership. Payments of income pursuant to this right do not affect the adjusted cost base of the residual interest, and either may exist irrespective of the existence or non-existence of the other. Whether a payment to a retired partner is to be regarded as capital transferred to him in satisfaction of his/her residual interest, or income under subsection 96(1.1), depends upon the terms of the partnership agreement. Obviously, the first characterization may be more attractive to the former partner while the second may have a greater appeal to the continuing members of the partnership.

The taxation consequences of the death of a retired partner are similar in principle to those that follow from the death of an active partner. The deceased's residual interest is considered capital property. Thus it is deemed to have been disposed of immediately prior to his/her death for proceeds equal to its fair market value if subsection 70(5) is applicable, or its adjusted cost base if the successor is a spouse or a spouse trust and a subsection 70(6) rollover occurs. In either case, the successor is deemed to have acquired a right to receive partnership property rather than an interest in a partnership. Amounts paid by the partnership in satisfaction of the right are deducted from the adjusted cost base and, if this becomes a negative amount, a capital gain will arise.

If, at the time of his/her death, the retired partner had a right to receive income under an agreement of the type specified in subsection 96(1.1), this right is not capital property. Rather, it is a right or thing to which the provisions of subsection 70(2) and 70(3) apply. As the right to income is quite independent of, and is not reflected in the value of the residual interest in the partnership, there is no problem of double taxation and the value of the right or thing will not be added to the adjusted cost base of the residual interest.

If income resulting from the deceased's right to a share of the partnership profits has been taxed under either of the alternatives in subsection 70(2), the general rule in paragraph 69(1)(c) will apply and the estate or the beneficiary who ultimately receives the right will acquire it at a cost equal to its fair market value. The beneficiary will be deemed to be a member of the partnership by virtue of subsection 96(1.1), and his/her cost will give rise to a deduction under subsection 96(1.3) as the income is allocated to him by the partnership. If the right is transferred to a beneficiary within the time specified for the application of subsection 70(3), the beneficiary will acquire the right at a cost equal to the cost, if any, to the deceased, and this amount will be deductible under subsection 96(1.3) as the income is allocated.

Where the partnership agreement stipulates that the retired partner will receive income from the partnership until death with a guaranteed period which has not expired by the date of death, it is possible that only the right to receive income from the end of the partnership's last fiscal period to the date of death will be a right or thing for the purposes of subsection 70(2). Arguably, the estate or the beneficiary who is to receive the income for the remaining part of the period would be deemed to be a member of the partnership under subsection 96(1.1) and taxable under this provision. [See IT-278R2, September 26, 1994, "Death of a Partner or of a Retired Partner"].

iii. Limited Partnerships

When a taxpayer is a member of a limited partnership, the same provisions as for general partnerships apply, with a few noted exceptions. Income or loss from business or property from January 1 to the date of death is included in the final return. Whether the limited partnership share(s) are business income or property income depends on the treatment of the share(s) by the taxpayer. The distinction between income and capital often turns on the taxpayer's intention.

If income at the end of the year is allocated to the deceased partner, it will be a right or thing pursuant to subsection 70(2). According to the CRA[19], if the deceased partner is allocated a share of the limited partnership loss, it represents loss from business or property where the adjusted cost base has been reduced by the amount of the loss. Interest expense related to acquiring the limited partnership share(s) cannot be deducted from the value of the right or thing, but is deductible in computing the income or loss from business or property. If the limited partnership share(s) are able to flow-through Canadian exploration expenses or Canadian development expenses to partners, a deceased partner will not be able to take advantage of these additional deductions in the year of death as they will not be a member of the partnership at its fiscal year-end when the flow-through amounts are determined. However, if the estate is a member of the partnership at the fiscal year-end, they can claim these expenses as allocated.[20]

6. LIFE ESTATES

Previously, one method of avoiding the full impact of the deemed disposition rules on death but retain enjoyment of real property, was to transfer the property to a child or other beneficiary but retain a life estate or *estate pur autre vie.* In 1992, provisions were added to

[19] CRA Views, Interpretation External, 2006-0177471E5, July 27, 2007.
[20] CRA Views, Interpretation External, 2006-0216201E5, January 19, 2007.

make such transfers a taxable event. Where the provisions apply, the taxpayer is deemed to have disposed of the entire property for proceeds equal to its fair market value and to immediately reacquire the life estate interest at its fair market value. The result is a realization of any capital gain that has accrued on the entire interest in the property at the time the remainder interest is disposed of. Section 43.1 does not apply if the remainder interest is disposed of to a registered charity or certain other donees such as federal or provincial governments listed in section 118.1.

On the death of the measuring life for the life estate, the life estate terminates. The person holding the remainder interest in the property at the time of death then acquires the entire interest in the property. The life estate holder is deemed to have disposed of the life estate immediately before death for proceeds equal to its adjusted cost base. Thus, no further capital gain or loss will arise. If the deceased and the holder of the remainder interest were not dealing at arm's length immediately before the death, the adjusted cost base of the real property is increased by an amount by which the fair market value of the entire property exceeds the adjusted cost base of the remainder interest at that time. As a result, any loss on the termination of the life estate will not result in a capital loss to the deceased life estate holder. A planning opportunity exists if the remainder interest is disposed of shortly after the asset is acquired, for example to a child. This will cause a deemed disposition under section 43.1 at a time when it is unlikely a large capital gain would result. Any further capital gain will not be recognized on the death of life estate holder, but deferred until the property is subsequently disposed of by the child.

7. TAXABLE CANADIAN PROPERTY

The deemed disposition provision in subsection 70(5) generally applies where a non-resident individual dies owning taxable Canadian property. Taxable Canadian property (TCP) includes an interest in real property, capital property used in a Canadian business (including eligible capital property and inventory), some trust and partnership interests, unlisted shares in private corporations resident in Canada, unlisted shares of non-resident corporations that derive more than 50% their fair market value from Canadian real estate or resource properties, certain listed shares if the taxpayer and non-arm's length parties owned 25% or more of the issued shares of any class of the capital stock, units of unit trusts, certain mutual fund trusts and certain interests in resident and non-resident trusts. The definition also includes any interest in or option in respect of taxable Canadian property, whether it currently exists or not. Thus an option to acquire shares in a corporation to be incorporated in the future would be caught by the definition. As a result of the March 2010 Budget, many of the shares currently considered to be TCP will be removed from the list.

In the ordinary case, no rollover to a spouse or common-law partner would be available with respect to taxable Canadian property since one of the conditions necessary to achieve a deferral under subsection 70(6) is that the deceased taxpayer be a Canadian resident for Canadian tax purposes. Thus, a non-resident would fail to meet this threshold requirement. A rollover is now available under subsection 70(6) if the deceased was a U.S. resident and the property passes to that U.S. resident's spouse, common-law partner or in some cases to a "conjugal trust." This rollover is possible as a result of the Third Protocol to the Canada-United States Tax Treaty. Article XXIX B(5) deems the deceased taxpayer and the surviving spouse or common-law partner to be resident in Canada immediately before the taxpayer's death for the purposes of subsection 70(6). Similarly, a trust that would be a conjugal trust under subsection 70(6) if its U.S. resident trustees were Canadian residents may qualify for rollover treatment on application to the competent authority.

8. PROCEEDS OF LIFE INSURANCE

Generally, the recipient of life insurance will not be subject to tax on the insurance proceeds. However, if immediately prior to his/her death, the deceased as a policyholder had an interest in a policy on the life of some other person, the death of the policyholder will result in a disposition of the policy for tax purposes. If the policy is an exempt policy, the difference between the value of the interest and the adjusted cost basis of the policy will be included in computing his/her income for the terminal year [subsection 148(7)]. If the interest in a life insurance policy has been transferred to a surviving spouse or common-law partner as a consequence of death, a rollover is available under subsection 148(8.2). The surviving spouse or common-law partner will acquire the life insurance policy at its adjusted cost basis. Like other conjugal rollovers, the application of this subsection is automatic unless an election is made in the policyholder's return of income for the year not to have the subsection apply. Unfortunately, the same does not hold true where a life insurance policy on a child's life, owned by the parent, is transferred to the parent by will. Ordinarily, subsection 148(8) would provide the rollover where the transfer is *inter vivos*. However, the CRA has stated that subsection 148(8) would not apply on death because the property is first transferred to the estate under the will and not directly to the child.

9. OTHER PROPERTY OF THE DECEASED

In addition to the properties already discussed, the taxpayer may own other assets including deferred income pension plans such as Registered Retirement Savings Plans ("RRSPs" , registered retirement income funds ("RRIFs") or deferred profit sharing plans ("DPSPs"), Registered Pension Plans ("RPPs"), or a Tax Free Savings Account (TFSA). Each of these may create tax liability on death. The taxpayer may also be able to take reduce taxable income under of the pension income splitting provisions.

RRSP'S and RRIF's

As a general rule, all amounts received by a taxpayer from an RRSP are fully taxable as ordinary income in the year of receipt, whether received as retirement income, in the form of annuity payments, as a return of premiums on the collapse of the plan [subsection 146(8)], or upon the annuitant's death [subsection 146(8.8)].

Notwithstanding this general rule, special provision has been made for the receipt of RRSP proceeds on the death of the annuitant. If the plan has not matured meaning the deceased is not 71 or older[21], the amount in the plan is included in the deceased's income for the terminal year unless all or a portion of the plan qualifies as a "refund of premiums"

[21] The 2007 Budget increased the conversion age from 69 to 71 years of age.

[subsection 146(8.9)]. To qualify as a refund of premiums, the amount must be paid to, or deemed to have been received by, the surviving spouse or common-law partner of the annuitant or children or grandchildren of the deceased who were financially dependent on the deceased. A refund of premiums is deducted from the deceased's income, with the result that there is no tax liability for the deceased, if all proceeds qualify as a refund of premiums. For this purpose it is assumed, unless the contrary is established, that a child is not financially dependent on the annuitant for support at the time of the annuitant's death if the child's income for the preceding taxation year exceeded basic personal income limits described in subsection 118(1). This amount equals $10,320 for 2009 and is indexed for inflation. If the child, is mentally or physically infirm, the amount was increased. by $6,180 in 2003 , an amount that continues to be adjusted for inflation. It should also be noted that External Interpretation 2006-0189141E5 recognizes the possibility of having both a spouse and common-law partner for the purposes of the RRSP and RRIF legislation. This is a question of fact but can occur where the deceased is legally married and living in a common-law relationship with a different individual.

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If the spouse, common-law partner or eligible dependent is designated as the beneficiary under the provisions of the retirement plan, the plan proceeds will not fall into the estate of the deceased for most purposes and will be payable directly to the beneficiary. If amounts in an unmatured plan are payable to the estate of the deceased, they will qualify as a refund of premiums if they are allocated to, and distributed by, the personal representative to the spouse, common-law partner or the dependant, as the case may be [subsection 104(27)]. If, however, the personal representative is obliged to retain and invest the amounts received out of the plan, subsection 146(8.1) permits the spouse, common-law partner or eligible dependant, to designate jointly with the personal representative that the amounts are deemed to have been received by the spouse, common-law partner or dependant as a refund of premiums.

Currently, RRSP distributions paid to a deceased's surviving spouse or partner or a disabled dependent child may be transferred to the recipient's RRSP, resulting in a deferral of tax. For deaths occurring on or after 4 March 2010, this tax-deferred rollover rule is available on a transfer of a deceased individual's RRSP proceeds to a registered disability savings plan (RDSP) of a financially dependent infirm child or grandchild. The RDSP beneficiary or his/her legal representative must make an election to transfer the eligible RRSP proceeds to an RDSP on a rollover basis. The amount of RRSP proceeds eligible for rollover to an RDSP is limited to a beneficiary's available RDSP contribution room (the lifetime maximum is $200,000). However, unlike other contributions, the transferred amount will not attract Canada Disability Savings Grants (CDSGs). The transferred amounts will form part of the taxable portion of disability assistance payments, resulting in an income inclusion when withdrawn from the plan

The amount of any refund of premiums is included in the income of the actual or deemed recipient in the year it was received. If the recipient is the spouse or common-law partner of the deceased and the amount is received or deemed to be received before the end of the year in which he or she attains the age of 71 years it can be rolled into an RRSP or an annuity contract without any tax liability in the year it is received [subparagraphs 60(1)(iv) and (v)]. If the amount is received after the end of the year in which the spouse or common-law partner attained the age of 71, the only option available to prevent tax liability is to purchase of an annuity contract.

A refund of premiums received, or deemed to be received, by a child or grandchild of the deceased may be used to acquire a qualifying annuity contract. If the dependant child or grandchild is under the age of 18, the entire lump sum can be used to purchase a fixed-term annuity for the benefit of the child provided that the term of the annuity, in years, is not greater than 18 minus the beneficiary's age. The refund of premiums can also be received by the child through a trust as long as the child is the only person beneficially interested in the trust. Where the child who was dependent upon the deceased annuitant as the result of a physical or mental infirmity, there is a full and unfettered rollover to a child (or to a trust under which the child is the sole person beneficially interested while he or she is alive) for a life annuity or a term annuity up to age 90. The infirm dependant may also transfer the refund of premiums to an RRSP or RRIF.

Where the annuitant dies after the maturity of the plan, the general rule is that an amount equal to the fair market value of all of the property of the plan will be included in his/her income for the terminal year, except to the extent that any part of such property qualifies as a refund of premiums to dependent children, or the surviving spouse or common-law partner is entitled to receive payments under the plan. In the latter case, he or she becomes the annuitant for the purposes of the Act and will be taxed on the payments as they are received. Alternatively, the spouse or common-law partner could roll the amount in the matured plan into his or her own unmatured RRSP if he or she has not attained the age 71, or to a RRIF or to an annuity if he or she is 71 or older. If payments from the mature plan are to be made to the personal representatives of the deceased "for the benefit of the spouse or common-law partner of the deceased," the personal representatives and the beneficiary may jointly elect to have the beneficiary deemed to be the annuitant under the plan [subsection 146(8.91)]. If the amount is received by a child as a refund of premiums, the amount may be rolled into or used to purchase a qualifying annuity for the child.

Similarly, all amounts received out of or under an RRIF are generally received as income. If the annuitant dies, the fair market value of the remainder of the fund is included in income in the year of death [subsection 146.3(6)]. This result will be avoided if the annuitant has elected to extend the benefits to his/her spouse or common-law partner. In that case, if the annuitant dies before all the payments contracted for have been made, the remaining payments are continued in favour of the surviving spouse or common-law partner. As with RRSPs, taxation in the terminal year will also be avoided if all or a portion of the amount paid into the plan is paid to a financially dependent child or grandchild of the deceased as a designated benefit, which is defined as an amount that would qualify as a refund of premiums if the fund were a registered retirement savings plan. A deduction is also available to offset the recipient's income inclusion where the eligible amount is transferred to an RRSP, RRIF or an annuity under which the child or grandchild is the annuitant. As with RRSP’s there is a presumption of financial dependency if the child's income did not exceed $10,382 in 2010 or, if the child is mentally or physically infirm.

As a result of the 2009 Budget a new relieving rule will apply to RRSPs and RRIFs that are wound up after 2008 where the fair market value of the deceased's plan declines after the taxpayer's death. The new rule will apply if the RRSP is wound up within the year following the year of death (the tax exempt period) and the RRSP has not held any non-qualifying investments post-death. Similar conditions apply to a RRIF. The new rule will allow losses incurred after the annuitant's death to be carried back and deducted against the year of death RRSP/RRIF income inclusion.

RPP's

Rollover treatment is available for lump sum payments received out of a RPP by a financially dependent infirm child or grandchild as a consequence of the death of a supporting parent or grandparent. In determining eligibility for the rollover, subsection 146 (1.1) includes a rebuttable presumption that an infirm child is not financially dependent, if for the year preceding the parent or grandparent's death, the income of the child or grandchild exceeds a specified amount. The child may claim an offsetting deduction if the amount is paid into his or her RRSP or RRIF or is used to acquire a specified annuity for his or her benefit.

TFSA

The 2008 Budget introduced the Tax Free Savings Account (TFSA), a registered savings account that allows taxpayers to earn investment income tax-free. Contributions to the TFSA are not deductible for tax purposes, but likewise withdrawals from the account are not taxable as income. Each individual is able to contribute up to $5,000 to their TFSA for 2010. When the holder of a TFSA dies, they are considered to have received, immediately before death, an amount equal to the fair market value of all property held in the TFSA. This amount is not taxable. All earnings that accrue after the TFSA holder's death are, however taxable to the beneficiaries once payments exceed the fair market value of all TFSA property at death. A holder of a TFSA can name their spouse or common-law partner the sole beneficiary of the TFSA in which case the spouse or common-law partner becomes a successor holder of the plan.

A TFSA becomes a trusteed arrangement and is deemed to continue until the end of the calendar year following the year in which the holder dies (the exempt period). During this period, all income earned is included in the income of the survivor; however, the survivor can contribute these payments to their own TFSA without affecting their unused TFSA contribution limit (an exempt contribution). The exempt contribution(s) cannot exceed the payment(s) received during the exempt period and the fair market value of the deceased's TFSA at the time of death. If the TFSA is to be transferred to a qualified donee, such as a registered charity, then this must occur within the 36 month period following the TFSA holder's death.

Pension Income Splitting

Section 60.03 allows a taxpayer to allocate up to 50% of their eligible pension income to their spouse or common-law partner. According to the CRA[22], it is possible to take advantage of this provision in the year of death as long as the amount is pro-rated for the number of months the deceased was alive since the taxpayers will not be married or in a common-law partnership after the death of one of the individuals.

10. *CROSS-BORDER ESTATES*

While a detailed review of cross-border estates is outside the scope of this paper, one recent legislative enactment is of note. The 2008 Budget, will remove the requirement to obtain a Certificate of Compliance (section 116 clearance certificate) where there is a disposition of "treaty-exempt property" (i.e. excluded disposition). This should speed up the paperwork of estate administration where a Canadian's estate is wound up and proceeds are distributed to a non-resident beneficiary, such as a US citizen.

III. DEDUCTIONS, CREDITS AND EXEMPTIONS

1. DEDUCTIONS

Subject to a few special rules, the deductions that would have been available to the deceased if he or she had lived may be taken for the purpose of computing income or tax payable for the terminal year. In addition, a number of options or elections are available to relieve some of the tax burden that otherwise results from the deemed disposition rules on death. These special options and elections in most cases provide more flexibility than the general taxing provisions would otherwise allow.

A. From Income

i. Reserves

During taxation year prior to the year of death the taxpayer may have been entitled to a variety of deductions with respect to amounts that would otherwise have been included in his/her income for the year but for the fact that the amounts were not payable until some time in the future. For example, under subparagraph 40(1)(a)(iii) a taxpayer who disposes of capital property is, permitted to claim a reserve with respect to proceeds that are not due until a future year. A similar reserve is available under subparagraph 44(1)(e)(iii) in respect of replacement property where payment is not due until a later year. They will give rise to a gain of the taxpayer in the year in which the amounts become payable. Similar reserves are permitted for unpaid installments of the purchase price of property sold by the deceased in a business and for unearned commissions of insurance agents or brokers. Consistent with the policy of taxing the value of the deceased's unrealized rights to income for the year of his/her death, such reserves are generally not deductible in the year of death. An exception is made if the right to the amount in respect of which the reserve was allowed is transferred or distributed to the spouse or common-law partner of the deceased or to a trust for a spouse or common-law partner as a consequence of the death. In that case a deduction in respect of a reserve may be claimed for the terminal year if the personal representative and the transferee so elect. Thereafter the reserve is treated as if it had been acquired originally by the spouse, common-law partner, or the conjugal trust, as the case may be [subsection 72(2)].

[22] CRA Views 2008-0275731E5.

ii. Capital Gains Deduction

A discretionary deduction in computing the taxable income of an individual resident in Canada (other than a trust) is available in respect of net taxable capital gains realized in the year. This deduction is available where taxable capital gains resulted from a deemed disposition on death under subsection 70(5).

The maximum lifetime capital gains deduction for an individual is $750,000 for dispositions after March 18, 2007 ($500,000 previously) of shares of qualifying small business corporations ("QSBC") and qualified farm or fishing property ("QFP"). Access to the deduction is restricted by a number of provisions in the Act discussed in more detail below.

QFP is defined in subsection 110.6(1) as: property owned by an individual, the spouse or common-law partner of the individual or a partnership, an interest in which is an interest in a family farm or fishing partnership of the individual or the individual's spouse or common-law partner that is:

- real property owned by an individual that is used in the course of carrying on the business of farming or fishing in Canada by the individual who owns it, his/her spouse, common-law partner or his/her children, his/her parents or a family farm or fishing corporation or partnership of the individual, his/her spouse, his/her common-law partner, his/her children or parents;

- shares of a family farm or fishing corporation owned by an individual or his/her spouse or his/her common-law partner;

- an interest in a family farm partnership owned by an individual or his/her spouse or common-law partner; or

- eligible capital property provided certain requirements are satisfied.

Real property will only constitute QFP provided it is used in "carrying on the business of farming or fishing in Canada." There are different requirements that must be met to satisfy this test depending on whether the real property was acquired before or after June 17, 1987. Careful note should also be made of the different provisions that apply on rollovers of farm or fishing property to children as discussed above. Although many of the farm or fishing assets eligible for the rollover will qualify for the capital gains deduction and vice versa, the requirements of the respective provisions are such that will not always be the case.

QSBC shares will qualify for the deduction on gains from the disposition of QSBC shares where all of the following criteria are met [subsection 110.6(1)]:

- at the time of disposition the share must be a share of a Small Business Corporation ("SBC"); this requires among other conditions that all or substantially all of the assets be engaged in an active business in Canada;

- the shares or shares for which they were substituted cannot have been held by anyone other than the individual or related persons throughout the 24-month period immediately preceding the disposition (if the shares have been purchased from an arm's length third party and the new purchaser dies before the 24-month holding period expires no relief will be granted); and

- more than 50% of the fair market value of the assets of the corporation were used in an active business carried on primarily in Canada by the corporation or a related corporation, throughout the required holding period.

There are also provisions that prevent these requirements from being circumvented through the use of substituted shares. Basically these require that if a share has been substituted for another share during the 24-month holding period, the original share must have met the relevant tests in order for the substituted share to qualify as a QSBC share.

Three exceptions from these general rules are made where shares are disposed of as a consequence of death. First, where shares of the deceased shareholder would otherwise be QSBC shares immediately before the deceased's death, but fail to qualify because the corporation itself did not meet the definition of small business corporation at that time, a relieving provision is available. Paragraph 110.6(14)(g) provides that the shares will be treated as QSBC shares if the corporation was a SBC at any time in the 12 month period preceding the shareholder's death. As a result, a corporation that, for example, does not have "all or substantially all" of its assets engaged in an active business in Canada at the time of death will still be viewed as a SBC if the asset test was met at any time in the prior 12 month period.

Second, paragraph 110.6(14)(c) treats a beneficiary of a personal trust as being related to the trust while he or she is a beneficiary. This may assist the beneficiary in satisfying the 24 month period of ownership required to meet the definition of a QSBC share. In addition, a personal trust will be treated as being related, in respect of shares of the capital stock of a corporation, to any person from whom it acquired those shares, where at the time the trust disposes of the shares, all beneficiaries of the trust (other than registered charities) are related to the person from whom the trust acquired the shares, namely the deceased. This will allow the estate or trust to dispose of the shares within 24 months of the death and the beneficiaries to claim the deduction.

Third, special relief is offered with respect to life insurance policies owned by the corporation at the time of death. The fair market value of policy at any time prior to the taxpayer’s death is considered to be its cash surrender value at that time for purposes of the definitions of "qualified small business corporation share," "share of the capital stock of a family farm or fishing corporation," and "small business corporation" [paragraph 110.6(15)(a)]. Thus, where a corporation is the beneficiary of a life insurance policy under which a shareholder of that corporation (or certain other connected corporations) is the insured, the cash surrender value of the policy is used to determine whether the corporation meets the asset test.

Relief is also available if life insurance policy proceeds received by the corporation, as a result of a shareholder's death, are distributed by the corporation to fund an acquisition or redemption of shares under the terms of a buy-sell agreement. Specifically, the fair market value of such proceeds are treated as not exceeding the cash surrender value of the policy immediately prior to the shareholder's death to the extent that they are used, either directly or indirectly to redeem, acquire or cancel shares of the capital stock of that corporation (or of a connected corporation or a corporation connected to a connected corporation) that were owned by the person whose life was insured under the policy. In consequence, the redeemed shares will remain QSBC shares notwithstanding the infusion of life insurance proceeds to the corporation’s asset base. This relief is available only if the redemption, acquisition or cancellation occurs within 24 months after the death of the person whose life was insured under the policy, although the 24 month period may be extended upon written application to the Minister within that period.

The capital gains deduction provisions do not apply with respect to the separate tax returns that may be filed on the deceased's behalf. A choice will have to be made between filing the separate returns and benefiting from the lower marginal tax rates and multiple credits that may apply in the separate returns and having access to the capital gains deduction. Amounts claimed under section 110.6 as a capital gains deduction during an individual's lifetime or in the year of death will also operate to reduce the total net capital losses for all taxation years that can be deducted in the year of death against income from all sources under subsection 111(2).

iii. Capital Losses

Capital losses incurred by the deceased in his or her lifetime cannot be transferred to the deceased’s estate or to the deceased’s successors.

Allowable capital losses in the year of death and net capital losses carried over from prior years may be deducted from income from any source in the year of death and the previous taxation year (subsection 111(2)). Capital losses used against other income must first be reduced by the total capital gains deduction previously claimed by the deceased. Thus, any allowable capital losses that cannot be offset against taxable capital gains realized are only deductible against other income to the extent they exceed the total of all capital gains deductions previously claimed.

The deceased's personal representative may also elect under subsection 164(6) to treat all or part of certain capital losses and terminal losses realized by the deceased's estate in its first taxation year as those of the deceased in his/her terminal year. It is important to keep in mind this provision if a short taxation year for the estate is being considered, as this election is only available in the estate's first taxation year. Capital losses transferred in this manner may affect the capital gains deduction of the deceased under section 110.6 and result in a reduction in the deceased's tax. The capital losses that are eligible for this election are generally those that exceed the estate's capital gains in its first taxation year. The legal representative must, at or before the time of the election to transfer the losses, file an amended return for the deceased for the terminal year.

Unlike losses incurred in the year of death, which may be carried back to the prior year, losses transferred under subsection 164(6) may only be deducted in computing the taxable income of the deceased in the year of death. Provisions enacted in February 2005 (Bill C-33) with respect to trusts and affiliated persons will increase the importance of elections under subsection 164(6) if the estate plan includes a corporate redemption by the estate with an affiliated corporation. Specifically, notwithstanding that the estate is affiliated with the corporation immediately after the redemption, any loss otherwise deemed to be nil (subsection 40(3.6)) as a result of the disposition, is deemed not to be nil if the shares are disposed of by an estate, to the extent that a subsection 164(6) election is made.

B. Computation of Tax

i. Charitable Donations

Section 118.1 permits individuals to claim a non-refundable and non-transferable tax credit in respect of certain gifts made by them. The calculation of this credit is based on an individual's "total gifts" for the year as defined by subsection 118.1(1). Where the amount of total gifts for the year does not exceed $200, the tax credit is determined by multiplying 15% (the lowest personal tax rate in 2010 by the amount of total gifts. However, if the total gifts for the year exceed $200, the credit equals (15% x 200) + 29% (the highest personal tax rate) for the excess of total gifts over $200. An individual may claim *inter vivos* charitable gifts (other than gifts of cultural property or ecologically sensitive real property) up to 75% of income. For gifts of capital property, the income limit is increased by 25% of the capital gain or recapture that is included in income. None of these income restrictions apply in the year of death or the preceding year as an individual may claim qualifying charitable gifts up to 100% of income[23].

Under subsection 118.1(4), gifts made in the year of death (which, by virtue of subsection 118.1(5), include gifts made by will), are deemed to have been made in the immediately preceding taxation year to the extent that a credit is not actually taken in the year of death. This means that the unutilized portion of a donation may be used in calculating the tax credit available for the preceding year. To ensure that gifts made by will qualify for the credit in the terminal or prior year, the extent of the gift (specific property, amount or named percentage of the residue) should be clearly identifiable. The CRA is of the view that if the will grants the executor discretion to donate within a specified range, only the minimum in the range will qualify for the credit, in the terminal or preceding year's return. A donation over the minimum is considered to be at the trustee's discretion and may be claimed in the estate return only. It is no longer the CRA's administrative practice to require that the specific charity to which the gift is to be made be named; however, the will should be sufficiently specific to make clear that a charitable gift is intended.

[23] It should be noted that the CRA in Views 2008-0273641E5 stated that a gift of capital property by will under proposed subsections 118.1(5.4) and (6) will override the application of subsection 70(5).

A number of options are available with respect to gifts of capital property. Under the normal rules in paragraph 70(5)(a), when a taxpayer dies possessed of such capital property, it is deemed to have been disposed of by him or her for proceeds equal to fair market value. However, if the deceased makes a charitable or a Crown gift of that capital property, by will or otherwise, and the property has appreciated in value, the legal representative may elect to designate the amount of the gift at an amount not greater than the fair market value of the property and not less than the adjusted cost base. A similar rule applies to works of art described in inventory and donated by artists. The designated amount is deemed to be the value of the gift for purposes of determining the credit for charitable or Crown gifts and the proceeds of disposition of the property. The amount chosen should take into consideration the taxpayer's other capital gains or losses, charitable donations and income for the year and the capital gains deduction under section 110.6. Provision is also made for ecological gifts.

If the deceased makes a cultural gift of Canadian cultural property as certified by the Canadian Cultural Property Export Review Board, by will or otherwise, its value is used in determining the credit for cultural gifts. A capital gain on the disposition of property that is a cultural gift is specifically exempt from tax provided that the property is disposed of within 36 months after death. [See IT-288R2, January 16, 1995, “Gifts of Capital Properties to a Charity and Others”.]

There are also considerable gift planning opportunities around publicly traded securities. To encourage additional donations of listed publicly-traded securities to charitable organizations and public foundations, the 2006 Budget reduced the capital gains inclusion rate for such donations to zero. Notwithstanding, a charitable tax credit is still available based on the fair market value of the securities gifted. The March 2007 Budget also exempted donations of publicly listed securities made after March 18, 2007 to certain private foundations from capital gains tax. There was more good news in the 2008 Budget, as it further extends the favorable treatment to exchangeable securities where the unlisted securities include a condition that allows the holder to exchange them for public securities and such exchange is undertaken and the public securities are donated within 30 days of the exchange.

Additionally, an employee who deals at arm's length with their employer and acquires stock options will get an additional deduction to offset employment income if the stock options are donated to a private foundation within 30 days of acquisition. The 2007 Budget further proposes to limit the share ownership of private foundations based on the relative size of holdings by foundations and non-arm's length persons in a particular corporation. Additional planning opportunities are available with respect to charitable donations of RRSP's, RRIF's and insurance proceeds made as a consequence of direct beneficiary designations to a registered charity. Such donations are also eligible for the charitable tax credit.

Further, if a life insurance policy is gifted to a qualified donee, the fair market value of the policy at the time of the gift is relevant. The CRA recently clarified that factors such as the cash surrender value, the policy's loan value, the face value, conversion privileges, policy terms, and replacement value will be taken into account when determining fair market value of the life insurance policy[24].

ii. Medical Expenses

Section 118.2 allows a taxpayer to claim a tax credit for certain medical expenses. This credit is determined by multiplying 15% (the lowest personal tax rate) by the medical expenses paid within any twelve-month period ending in the year in excess of the lesser of $2,024 and 3% of income for the year, for 2010. In consequence, eligible medical expenses paid by the taxpayer or his/her legal representative within any selected period of 12 consecutive months, the last day of which falls within the taxation year in question, will qualify for purposes of the credit. For example, expenses paid in the period commencing on February 1, 2009 and ending January 31, 2010 would be eligible medical expenses for the taxpayer's 2010 taxation year.

[24] CRA Views 2008-0270391C6.

The 12 month period, within which medical expenses may be claimed, is extended to 24 months in the case of a deceased individual. The legal representative may claim in the year of a taxpayer's death, medical expenses paid by the representative or the taxpayer within any 24 month period that includes the day of death. This concession is to recognize the heavy medical expenses often incurred in the final illness of an individual, some of which may not be paid until after his/her death. Furthermore, according to External Interpretation 2006-0189561E5 these expenses can include homecare expenses previously rendered to the deceased individual. The CRA has also indicated that if the legal representative of a deceased individual has filed a return for the year of death and subsequently pays additional medical expenses, that an adjustment will be made in the medical expense tax credit if requested, to reflect such payments.

2. ALTERNATIVE MINIMUM TAX

There is no obligation to pay alternative minimum tax (AMT) in the year of death. Nonetheless the AMT provisions may affect the terminal return. For example, a taxpayer may carry forward the excess of his/her AMT over regular Part I tax in a particular year for seven years ("AMT carry forward"). Where tax that would otherwise be payable under Part I exceeds the minimum amount in a particular year ("Part I tax excess"), any unclaimed AMT carry forward may be used to reduce the Part I tax excess. As a result, tax that would otherwise be payable under Part I may be reduced by an AMT carry forward. The AMT carry forward provisions do not apply with respect to the separate returns that may be filed on the deceased's behalf.

Given that AMT is not payable in the year of death, the legal representative should consider any elections that would result in the realization of capital gains on the deemed disposition of the deceased's qualified farm or fishing property or qualifying shares of a small business corporation. If the property were bequeathed to a spouse or common-law partner a rollover would otherwise occur. If the personal representative elects under subsection 70(6.2) to have subsection 70(5) apply and claims the capital gains exemption, the cost base of the property is increased without the possible penalty of AMT.

3. OTHER SEPARATE RETURNS

In addition to the separate returns that may be filed for rights and things, separate returns may be filed if the deceased had income from a testamentary trust, a partnership of which he/she was a member, or a business of which he/she was the proprietor, if the death occurred after the close of the taxation year of the trust, partnership or business and before the end of the calendar year in which the taxation year ended. Such occurrences are, except in the case of a beneficiary or a testamentary trust, somewhat limited. Changes to the definition of fiscal period in section 249.1 (for fiscal periods after 1994) now generally require that the fiscal period of proprietors and partners must end in the calendar year. Notwithstanding, important opportunities to file a separate return remain.

The first is with respect to the transitional reserve in respect of December 31, 1995 income. If an individual or partnership had a fiscal period other than December 31, 1995, they must bring that 1995 income into taxable income, subject to a 10-year reserve. If the individual dies before the reserve is exhausted, the legal representative may claim the remaining reserve in the year of death and report it as income on a separate return under subsection 150(4).

The second occurs if the individual reports business income on an off calendar year basis and has filed the appropriate election under subsection 249.1(4). Under those circumstances, a separate return may be filed under subsection 150(4) if a second fiscal period results in the calendar year as a result of the death. Note that an adjustment is required under subsection 34.1(9) to recognize income that would otherwise have been earned in the calendar year and to prorate its inclusion in the terminal return. This amount is deductible from the return under subsection 150(4). The ability to file a separate return will, of course, also remain available to the beneficiary of a testamentary trust.

Subsection 150(4) provides that tax on the income reported in a separate return shall be paid as if the income were the income of another person. However, a number of special rules apply. For example, the deductions that may be claimed on those returns include the stock option deductions, the prospector and grubstaker's deduction, the employer's shares deduction, certain payments such as workmen’s compensation and social assistance, unemployment insurance benefit repayments, the home relocation loan deduction, and gifts to a religious order. These deductions may be divided among the terminal returns, but the total amount deducted among all returns must not exceed what could have been deducted if all income of the deceased was reported on the ordinary return. The personal credits (that is, basic personal, married, dependant children, and other dependants) and the age credit may be claimed on each separate return as well as on the ordinary return. The ability to claim multiple credits is one of the main reasons for filing separate returns. Certain other credits may be claimed on the separate returns and may be divided among the terminal returns; but again the total amount claimed is limited to what could have been claimed if all the deceased's income was reported on the ordinary return. (See IT-326R3, November 13, 1996, Returns of Deceased Persons as “Another Person”.)

APPENDIX 1

Post Mortem Planning

Mr. Deceased Dentist: Date of Death - November 19, 2009. At the time of death, he owned the following:

				Taxable Income	Comments on Property
Income: 1. $9,000 declared, but unpaid, dividends (Sun Cap). 2. Apartment building earned $3,000/month. Rent due at month end. 3. Earned income $120,000 annually from dental practice. Earnings to date $80,000.					
Other Assets	FMV at Death	Cost Amount	Left by Will to		
AT&T Shares	$90,000	$120,000	Spouse		
Olympia & York Shares	60,000	10,000	Spouse		
Sun Cap* Shares (QSBC)	1,000,000	50,000	Estate		
Vacant Lots (3)	90,000	10,000	Daughter		
Apartment building (UCC)	180,000	150,000 40,000	Son		
Bonds	50,000	50,000	Spouse		
RRSP	128,000	128,000	Estate		
Insurance	200,000	--	Estate		
Principal Res. (jointly held)	250,000	50,000			
Works of Art	150,000	10,000	Museum		
Total	$2,200,000				
Notes: Estate to be divided equally among the three beneficiaries. *There is a life insurance policy owned by Sun Cap on deceased's life.					

1. If the executor takes no steps, what will the tax result be in the terminal year?

2. How might a well-advised executor improve this tax position? What elections may be made or steps taken?

				Taxable Income	Comments on Property
Income: 1. $9,000 declared, but unpaid, dividends (Sun Cap). 2. Apartment building earned $3,000/month. Rent due at month end. 3. Earned income $120,000 annually from dental practice. Earnings to date $80,000.					
Other Assets	FMV at Death	Cost Amount	Left by Will to		
AT&T Shares	$90,000	$120,000	Spouse		
Olympia & York Shares	60,000	10,000	Spouse		
Sun Cap* Shares (QSBC)	1,000,000	50,000	Estate		
Vacant Lots (3)	90,000	10,000	Daughter		
Apartment building (UCC)	180,000	150,000 40,000	Son		
Bonds	50,000	50,000	Spouse		
RRSP	128,000	128,000	Estate		
Insurance	200,000	--	Estate		
Principal Res. (jointly held)	250,000	50,000			
Works of Art	150,000	10,000	Museum		
Total	$2,200,000				
Notes: Estate to be divided equally among the three beneficiaries. *There is a life insurance policy owned by Sun Cap on deceased's life.					

3. How might a creative tax planner further improve this situation?

				Taxable Income	Comments on Property
Income: 4. $9,000 declared, but unpaid, dividends (Sun Cap). 5. Apartment building earned $3,000/month. Rent due at month end. 6. Earned income $120,000 annually from dental practice. Earnings to date $80,000.					
Other Assets	FMV at Death	Cost Amount	Left by Will to		
AT&T Shares	$90,000	$120,000	Spouse		
Olympia & York Shares	60,000	10,000	Spouse		
Sun Cap* Shares (QSBC)	1,000,000	50,000	Estate		
Vacant Lots (3)	90,000	10,000	Daughter		
Apartment building (UCC)	180,000	150,000 40,000	Son		
Bonds	50,000	50,000	Spouse		
RRSP	128,000	128,000	Estate		
Insurance	200,000	--	Estate		
Principal Res. (jointly held)	250,000	50,000			
Works of Art	150,000	10,000	Museum		
Total	$2,200,000				
Notes: Estate to be divided equally among the three beneficiaries. *There is a life insurance policy owned by Sun Cap on deceased's life.					