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TAX LETTER

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TAX CONSIDERATIONS FOR EXECUTORS
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TAX CONSIDERATIONS FOR EXECUTORS

Being asked to be the Executor of someone's estate is a significant responsibility, often coming at a very sad time if that person is a family member. The responsibility is not something which should be taken on lightly. The estate administration process can sometimes take years to complete.

There are a multitude of practical tasks and duties to undertake in order to ensure that the estate is gathered in and ultimately distributed to the intended beneficiaries. The Executor's duties involve ingathering the estate, making sure all debts of the deceased are paid (including tax liabilities), locating and contacting all beneficiaries, and ultimately making sure that all beneficiaries receive what they are entitled to.

Tax is often an afterthought during this process, however there are a number of important tax filing responsibilities and deadlines which should be kept in mind at the outset. Some of these facilitate the mitigation of tax on the estate.

When a person dies, they are deemed to have disposed of, and re-acquired, all of their assets for fair market value at the time of death. This means that any unrealized gains on assets are realized at the time of death, with tax on those gains due in that year. This also means that the ultimate beneficiaries receive the assets at a cost equal to fair market value.

Register with CRA

One of the first tax steps is to notify CRA of the death and to register as the Executor of the estate. This allows you to deal with the tax matters as the recognized representative of the deceased. Information on how to register can be found here.

In order to register, the Executor should gather a copy of the deceased's death certificate, a copy of the Will (if the deceased left a Will), a copy of the grant of probate (or letters of administration if the deceased did not leave a Will), and the deceased's social insurance number. If the deceased did not leave a Will, a Form RC552 must also be completed as part of the CRA registration process.

This registration should be undertaken early in the estate administration process. The CRA currently estimate access being granted around 28 business days following the registration, although it can often take longer than this.

Final T1 return

The first tax return that the Executor will likely have to complete is the deceased's final T1 personal tax return, which covers the period beginning January 1 in the year of death up to the date of death (known as a Terminal T1).

In this return, the deemed disposition of the deceased's assets on death must be reported, as well as income received by the deceased up to the date of death.

Previous tax returns of the deceased can assist with locating sources of income. Professional advice should be sought, as there may be an apportionment of income required in respect of various sources. A number of exemptions and credits can also be claimed in the year of death.

A search of the deceased's documents may uncover details of an accountant or other advisor who had been preparing the deceased's tax returns and may be of assistance.

Be aware in particular of certain income sources which arise as a result of death. For example, the value of a deceased's RRSP may need to be reported as income in the Terminal T1, depending upon whether any successor beneficiaries have been designated.

The deadline for filing the Terminal T1 is April 30 in the year after the date of death if the individual died in the first 10 months of the year. If they died in the final 2 months of the year, the deadline is 6 months after the date of death. If the deceased was self-employed, the filing deadline is extended to June 15 if the individual died before December 16 (or 6 months from the date of death if they died after December 15).

If the Terminal T1 is filed late, there may be penalties and interest applicable, which the Executor may become personally liable for!

T3 Estate return

In the course of the administration of the estate, it is likely that some of the deceased's assets may continue to earn income or realize gains. For example, if the deceased held portfolio investments, it may take some time to liquidate these. A T3 estate return must be filed to report any income or gains arising after the deceased's death. This must be filed every year until the estate is finalized.

An estate is essentially a trust for tax purposes. Most trusts pay income tax at the highest marginal rate, which makes the tax

burden significant. However, an estate can designate itself as a "graduated rate estate" for tax purposes, provided that various conditions are met and that the estate makes this designation in its first T3 return.

The graduated rate estate designation can apply for up to 36 months immediately following the deceased's death. The major benefit of this designation is that the estate becomes entitled to the same tax rates and brackets as an individual, which can drastically lower the tax payable by the estate.

The filing deadline for the estate return is 90 days after the end of each taxation year of the estate. The Executor can select any date to be the taxation year end, but must then be consistent with this date each year.

As discussed below, the selection of an estate year end can impact upon the timing of various planning transactions which may be available, so a professional should be consulted prior to selecting the first estate year end.

Rights or things return

A third, optional, return is known as a rights or things return. This return can be filed to report income which the deceased was entitled to at the date of their death, but which had not yet been paid.

Examples of such income include salary payments and dividends which had been declared prior to death.

While these amounts can be reported in the deceased's terminal T1 in order to avoid the additional return, the major benefit of a rights or things return is that the return is entitled to separate tax brackets and certain tax credits.

This means, together with the terminal T1, that marginal tax brackets may be "doubled up". If the deceased had significant accrued but unpaid income at the time of death, the tax savings could be substantial and well worth the time and expense of filing an additional return.

The deadline for filing a rights or things return is the **later** of (i) 90 days from the date of the Notice of Assessment received following the filing of the Terminal T1, and (ii) one year after the date of death.

Other tax returns

One of the Executor's duties is to make sure that the deceased is fully up-to-date in respect of their tax filing obligations. This extends to returns for previous years, if the deceased did not do this prior to his death. If the deceased was deficient in their tax filings over several years, this could turn out to be quite an onerous, and expensive, process.

Clearance certificate

Once all required tax returns are submitted, and tax paid (and after settlement of all other liabilities), the remaining estate can be distributed to beneficiaries in accordance with the deceased's Will.

However, a common final procedure prior to distributing assets to beneficiaries, and a highly-advised one, is to apply to the CRA to obtain a clearance certificate.

This certificate confirms that all taxes have been filed and paid, and that there is no outstanding tax liability in relation to the deceased or the estate. The receipt of a clearance certificate protects the Executor from liability if any tax liabilities have been

missed. If the estate has been fully distributed, and a tax liability then comes to light, the Executor may need to pay this tax personally!

A clearance certificate can take a while to obtain. The CRA estimate that it takes around 120 days to process, although anecdotally it can take a lot longer than this. Therefore, the beneficiaries should be advised in advance of the requirement for this, and that they may not receive their full entitlement for some time.

Tax planning considerations

There are a number of tax-planning options which can be undertaken in order to maximize the value of the estate which passes to beneficiaries, particularly if the deceased held private company shares.

Where shares are held at the time of death, there is the possibility of double, or even triple, tax in relation to the shares and the underlying assets of the corporation. For example, the deceased will pay tax on the gain in value of the shares at the time of death, however, the value still has to be paid out from the corporation to the estate, usually in the form of dividends (which are also subject to tax).

One way to avoid this double tax is to do a "loss carryback". Essentially, planning is undertaken to transfer or dispose of the deceased's shares. This disposition will usually result in a deemed dividend, but will also usually realize a capital loss (as the dividend amount reduces the amount considered to be received for the disposition). **This loss is allowed, in certain circumstances, to be carried back to the terminal T1 to offset the gains arising as a result of death.**

A loss carryback avoids double tax by replacing the capital gain on death with a dividend.

There are strict requirements which must be met in order to carry out this planning. Importantly, the estate must be designated as a graduated rate estate and the planning must be undertaken in the first taxation year of the estate. This is why it is important to carefully select an estate year end, as an early year end may make it impossible to undertake a loss carryback plan due to lack of time.

Another option to minimize or prevent double tax on death is known as a "post-mortem pipeline". Again, this can be undertaken in respect of private shares.

This planning involves the disposition of the shares (usually for no gain as the cost of the shares is increased as a result of the deemed disposition on death) and the subsequent issue of debt to the estate equal to the fair market value of the shares, which can be paid to the estate tax-free.

As with the loss carryback plan, there are strict conditions which must be met in order for this type of plan to be successful, particularly in relation to the ongoing operation of the business and the timing of repayment of the debt.

If a private corporation holds land or buildings, a third layer of tax may arise as the corporation may have to sell the building (and pay tax on any capital gain) before paying out proceeds to the estate. Additional planning is available in such a situation to "bump" the cost of underlying assets in the corporation. This is a complex plan which can be undertaken in conjunction with a

post-mortem pipeline to ensure that double and triple taxation is avoided.

In summary, if the deceased died holding private corporation shares, there are numerous, somewhat complex, planning options available to mitigate the tax risks associated with such shares.

The above discussion merely scratches the surface in relation to the taxation considerations arising in respect of a death. One of the first steps an Executor should take is to engage a professional advisor who can provide guidance and support throughout the entire estate administration process.

TAXATION OF CRYPTOCURRENCY

The volatility of cryptocurrency is well-known. Holding assets such as Bitcoin can result in huge gains in value over a relatively short duration. It can also result in huge losses.

As the holding of cryptocurrency is becoming more common, thoughts have turned to how such assets are treated from a tax perspective.

The CRA has released many information guides in relation to the taxation of cryptocurrency, to help investors, traders and "miners" understand their tax obligations. These guides can be found here.

The taxation of cryptocurrency generally follows basic taxation principles, as with any other asset. Cryptocurrency is treated as a commodity for tax purposes. The tax implications are determined by the reason that the cryptocurrency was acquired and/or the use to which it is put.

Investment

Given the volatile history of cryptocurrency such as Bitcoin, speculative investors can be attracted to purchasing crypto to hold, in the hope of experiencing booming growth in value, similar to that of the past. For these investors, provided that the holding is not part of a business activity (discussed below), the holding is likely to be treated as a capital asset.

Therefore, any growth in value of the holding will likely be subject to capital gains treatment. No tax should be payable until the holding is sold. Once sold, currently one-half of any gain arising would be subject to income tax.

In the event of selling the holding for a loss, one-half of the loss should be treated as an allowable capital loss, which is offset against any capital gains arising in the same year. Any remaining allowable loss should be able to be carried back to be offset against capital gains arising in any of the three previous tax years, or carried forward indefinitely.

Trading

Whether a person is considered to be a cryptocurrency trader is dependent upon that person's specific circumstances.

If a person buys crypto with the intention to make a profit, this is an indicator that they may be trading. Other indicators include the frequency of trades and the commercial nature of the activity (for example, does the individual spend significant periods tracking cryptocurrency markets? Do they provide trading services to others? Are they trading simply for fun (and therefore as a hobby rather than a business)?).

All of these factors need to be assessed, and a conclusion drawn. The CRA's conclusion may differ from that of the individual, meaning a potential fight down the road in relation to the correct tax treatment.

For cryptocurrency traders, gains will likely be treated as business income, meaning that the full amount should be subject to income tax. On the other hand, any losses should be business losses available for offset against other income in the year, in the previous three years, or in the following 20 years.

Mining

Cryptocurrency mining is an activity involving the use of computer equipment to solve complex mathematical questions. The output of such mining helps to establish the cryptocurrency itself. Miners are usually rewarded for their efforts with a portion of the cryptocurrency they have mined.

Again, an assessment of the facts must be undertaken. Mining generally points to a business activity, but it may also only be a hobby (and therefore not taxable) in certain circumstances. There may also come a point in time when a legitimate hobby becomes a business, depending on the trading factors mentioned above.

A large portion of the time however, profits from mining will be treated as a business activity, with the business profit and loss implications mentioned above.

Paying with cryptocurrency

Individuals will often purchase cryptocurrency in order to facilitate the purchase of an asset (for example, goods and services offered online). Cryptocurrency is not strictly a 'currency' in the sense that it is not equivalent to cash. Instead, it is seen as an asset which can be exchanged for goods and services (known as a 'barter' transaction).

Even if cryptocurrency is not purchased to hold as an investment, any gains arising during the holding period, however short, will likely still be subject to tax if the crypto is used as part of a barter transaction. In the absence of business indicators, the capital treatment in respect of investments should apply.

Be careful if you are a GST registrant. If the required business indicators [are] present, a barter transaction involving crypto may also be subject to GST based on the value of the cryptocurrency at the time of the transaction.

Reporting obligations

In some cases, cryptocurrency exchanges (where crypto is purchased) are proving to be as volatile as the currency itself! Therefore, the CRA recommends that records are kept on a regular basis, as there may come a point where the exchange is unable to provide historical trading information.

In order to accurately report cryptocurrency dealings, and to provide sufficient information to the CRA if they come calling, the CRA recommends that information such as transaction dates and amounts, addresses, transaction IDs, wallet records and any other transaction information available be kept by the individual.

WHY IS TAX SO COMPLICATED!?

This is a question that professional advisors are faced with on a regular basis. The current paper version of the Income Tax Act stretches to almost 2,000 pages! How did we get to this?

The answer partly lies in one of the most fundamental principles of the Canadian taxation system – integration.

The general premise of integration is that income should suffer the same total amount of tax irrespective of the entity that is used to earn the income.

For example, an individual who does business as a sole proprietor, and receives business income directly, should pay the same total tax as a person who does business using a corporation (where both corporate income tax and personal income tax is paid).

This sounds straightforward enough in theory. However, in practice, this is difficult to achieve given the various types of income receivable (business income, salary income, dividend income, etc.).

True integration (the simple concept above) is not possible due to these differences. Some business structures and provinces will be slightly more advantageous or disadvantageous from a tax perspective. However, integration works pretty well in minimizing these differences.

Dividend income example

To demonstrate how this principle can make things complicated in practice. Take the example of income earned in a corporation versus income earned individually

When income is earned by an individual, the tax implications are fairly simple – business profits are taxed at the personal tax rates for 'other income' and investment income is largely subject to personal dividend tax rates.

Integration provides that the same income earned through a corporation should have the same tax outcome. However, corporate income tax rates are lower than personal rates because it is understood that there will be a further layer of taxation when corporate funds are distributed to shareholders.

In addition, for business income, shareholders are likely to pay tax on this second layer at dividend tax rates, which are different from the 'other income' rates.

To add to this complexity, certain businesses are entitled to a reduced rate of income tax on their first $500k of business income (the small business rate), which further skews the total tax payable, and risks 'breaking' integration.

To counter this, a complex system of dividend credits and corporate refundable tax was required. This necessitated the introduction of a whole new type of corporate tax (known as Part IV tax), which introduced a refundable tax on corporations, refunded when dividends are ultimately paid to shareholders.

Tax planning

Many tax plans which exist, are also the result of integration. Because integration results in little or no tax benefits which are entity-dependent, tax planners try to work within the rules of the Income Tax Act to achieve an outcome which is not consistent with the principle of integration, therefore providing their clients with a tax benefit greater than normal.

The growing complexity of the Act means that, more and more, there are some sections

which do not properly integrate (no pun intended) with others, providing for the existence of "loopholes" where they can be found.

This necessitates the introduction of anti-avoidance provisions as and when such plans come to light, further adding to the length of the Act and its complexity.

So, what makes tax so complicated? Integration is, in part, the surprisingly simple answer!

WHEN CAN THE CRA NO LONGER REASSESS YOU? – ADDENDUM

In last month's letter, various situations were discussed with respect to how long the CRA have to reassess a return or election. There is one further situation worth mentioning, namely the filing (or, to be precise, non-filing) of a return for **a partnership**.

Generally, partnerships must file an annual T5013 information return, reporting the income earned in the partnership. However, the CRA have an administrative policy that doesn't require partnerships to file this annual return in certain circumstances, for example where the income plus expenses of the partnership for the year does not exceed a certain amount.

However, this has implications for the reassessment window for the year. Specifically, if a partnership takes advantage of the CRA's administrative policy and does not file a return for a year, the Income Tax Act provides that there is no limit on the length of time the CRA have to reassess that year. So, where no partnership return is filed, there is an **indefinite reassessment period.**

For this reason, it may be advantageous to file a return, even if one is not strictly required due to the CRA's administrative policy. Doing so will generate an original assessment which will start the three-year reassessment clock for that year, rather than giving the CRA an indefinite time period to come back and reassess the year.

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