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PROFESSIONAL **STRENGTH** PERSONAL **SERVICE** PRACTICAL **SOLUTIONS**

Death and income taxes

We all know the old saying about these two sure things in life. One sure thing—death—can result in additional income tax, due to the *"deemed disposition"* rule that applies on death.

DEEMED DISPOSITION RULE

Basically, the rule provides that on your death, you are deemed to have sold each capital property you own for its current fair market value. This is deemed to happen an instant before your death, so the resulting tax is triggered in your final return, not in your estate, although your estate is liable for the tax. *(An exception applies for spouses, as discussed below.)*

The person who acquires the property as a result of your death acquires the property at a cost equal to the same value at which you are deemed to have sold it. Similar rules apply to land inventory and resource properties owned at death.

For capital properties, the deemed disposition rule can result in either capital gains or capital losses being recognized in the deceased's year of death. As per the normal rule for capital gains, half of capital gains are included in income as taxable capital gains and half of capital losses are allowable capital losses. For depreciable property, the rule can also result in recapture of previously claimed capital cost allowance (tax depreciation), or a terminal loss.

To the extent your taxable capital gains from the deemed disposition exceed your allowable capital losses, the excess net taxable capital gains will be included in your income for the year of death. It will be added to any of your *"regular"* income that you earned or realized during the year before your death, such as from employment.

If your allowable capital losses exceed your taxable capital gains from the deemed disposition, the excess will reduce any taxable capital gains that may have been realized during the year from *"actual"* dispositions. Furthermore, if there are still allowable capital losses remaining (net capital losses), they can

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serve to offset other sources of income in the year of death or in the immediately preceding year (e.g. employment, business or property income). This is an exception to the general rule under which allowable capital losses can only offset taxable capital gains. However, the allowable capital losses that can offset other sources of income are reduced to the extent you claimed the capital gains exemption in any year (e.g. for gains from selling small business corporation shares).

FOR EXAMPLE: John died in 2014 and had a $20,000 net capital loss—$40,000 capital loss—triggered by the deemed disposition rule. In 2014 he also had $30,000 of business income and no other income. In 2013, he had $4,000 of net taxable capital gains. In 2012, he claimed a capital gains deduction of $5,000 and has not otherwise claimed the capital gains exemption.

Of the net capital loss of $20,000, $4,000 can be carried back to 2013 to fully offset the $4,000 of taxable capital gains in that year—retroactively reducing John's net taxable capital gains in that year to zero. Of the remaining $16,000, $11,000 can be used to reduce his income in 2014 (i.e. $16,000 minus the $5,000 capital gains deduction claimed in 2012).

Alternatively, the 2014 net capital loss does not have to be carried back. In this case, $15,000 ($20,000 net capital loss minus $5,000 previous capital gains deduction) could be used to offset income in 2014.

A similar rule allows unused net capital losses from years before death to offset all sources of income in the year of death or the preceding year, again after offsetting any remaining taxable capital gains of those years and after accounting for any capital gains exemption claimed in any year.

ROLLOVER FOR SPOUSES AND COMMON-LAW PARTNERS

If you leave property to your spouse—or common-law partner—a different rule applies. It provides that you are deemed to have disposed of the property at its tax cost and your spouse takes over the same tax cost. As a result, no income or gain is triggered by the deemed disposition. This is called a **tax-free *"rollover"***.

However, your legal representative (e.g., executor or estate trustee) can elect out of the rollover on a property-by-property basis. When this election is made, the property is subject to a deemed disposition at fair market value as discussed above. The election can be beneficial if the property has an accrued capital loss, since the loss will be triggered and can offset any taxable capital gains and possibly other sources of income as described above. It can also be beneficial to trigger a gain on a property, if the gain can be offset by losses that you have. That is, you won't pay tax on the gain, while your spouse will inherit a bumped-up cost equal to the fair market value of the property. Lastly, the election can be useful if it triggers a capital gain from small business corporation shares, or farm or fishing property, that are eligible for the capital gains exemption, to the extent you have a remaining exemption, and if so they will not be subject to tax.

In addition to the spousal rollover, there is a rollover that applies if qualifying farm or fishing property is left to your child, grandchild, or great-grandchild—including step-children, spouses of children, etc.

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AROUND THE COURTS

DOUBLE LIABILITY for the *same* corporate debt!

In the recent Syed appeal, a company's director and his sister-in-law ended up liable for the same GST debt of the company.

THE BACKGROUND

Syed and his brother ran an Indian restaurant in Montreal. Syed was the only shareholder and director of the company for the years in question. It reported losses year after year, and came to the attention of Revenu Québec (RQ), which administers the GST in Quebec.

THE AUDIT

The RQ auditor found the business' reported numbers not to be credible because:

- salaries deducted were too low for the number of employees;
- utilities were too high for the reported revenues; and
- input tax credit (ITC) claims were for purchases that were 66-87% of sales instead of the industry average of 30%.

All of this led the auditor to apply a ***"markup"* audit methodology**:

- using liquor purchases from the Quebec Liquor Board—which could be reliably determined;
- calculating what that should map into in total meal and alcohol sales; and
- calculating GST and Quebec Sales Tax from those revenues.

THE ASSESSMENT

RQ thus assessed the company for some $50,000 of unreported GST over four years, based on unreported revenues exceeding $700,000. On objection, this was reduced to about $44,000. When the company did not pay its assessment, had closed and had no assets, RQ assessed Syed personally—as director—for its GST debt.

The company had some cash when it closed. It paid $110,000 to Syed's brother's wife, Abida. RQ assessed her for the company's unpaid liability under the *"transfer of property"* rule, which permits assessment of a person to whom a related person with a tax liability transfers property.

Syed and Abida both appealed.

THE DECISION

The Tax Court dismissed Abida's appeal, and allowed Syed's appeal only to reflect some minor concessions by RQ in the calculation of the company's GST. The Court found that auditor's method of calculating the unreported income to be reasonable. Syed as director did not meet the *"due-diligence"* defence. Abida was also liable, as the company had paid money to her while it owed GST.

Although the Court did not discuss it, this case raises a question about duplicate liability. If Syed is liable as director and Abida is liable under the *"transfer of property"* rule for the same corporate debt, will either one get credit once RQ has collected sufficient funds from the other? It appears not, because the two provisions do not interact with each other. One hopes that RQ will not proceed to collect the company's debt twice. Unfortunately, the confirmation of the two appellants' debts by the Tax Court leaves them each with an established liability that RQ Collections officials may well seek to collect without paying attention to the origins of that liability. ■

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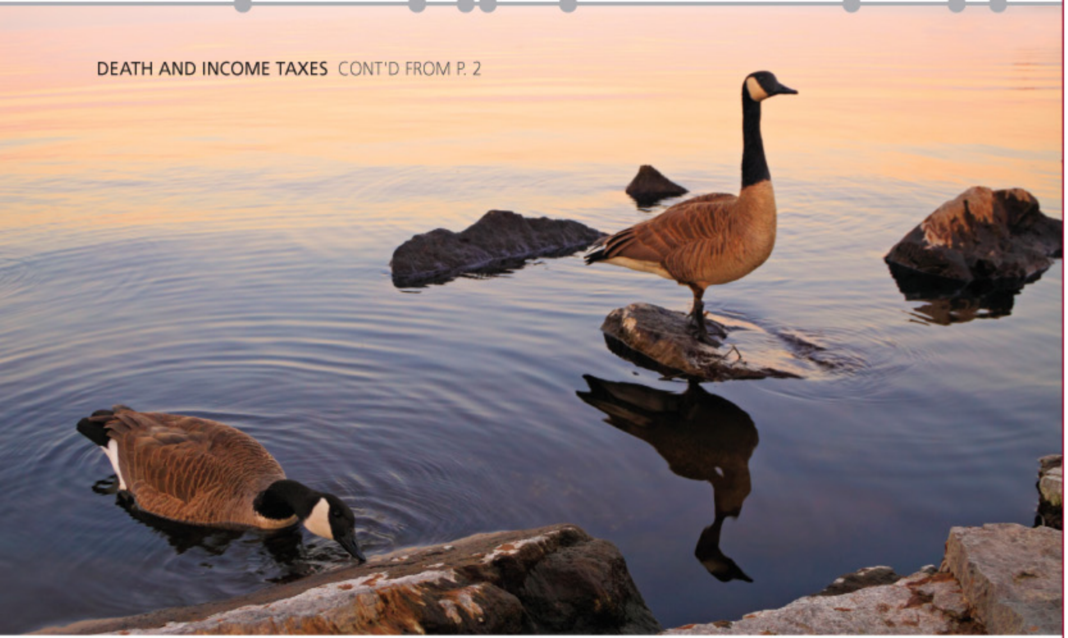

DEEMED ACCRUAL RULE

Another rule provides that any amount payable periodically but not yet paid—such as interest, rent, or employment income—is included in your income to the extent that it accrued up to the time of your death.

FOR EXAMPLE: *Assume you are paid a monthly salary that is paid on the last day of each month. If you die half-way through a month, the salary that accrued to that point in time will be included in your income in the year of death.*

ESTATE LOSSES

If your estate realizes capital losses in its first taxation year in excess of capital gains, the excess allowable capital losses can be carried back to your final taxation year and used in that year. However, they cannot be carried back to offset gains or income in earlier years.

RIGHTS OR THINGS

Rights or things are generally amounts receivable by you at the time of death that have not otherwise been included in your income. Rights and things include items such as declared dividends not yet paid, and receivable (declared) employment bonuses or other remuneration not yet paid for previous pay periods.

If your legal representative makes an election, the rights and things can be included in a separate tax return, treated as if they were received by a separate person. The benefit of this election is that this income is subject to the graduated tax rates otherwise applicable to individuals. Thus, the rights or things in the separate return will start being taxed at the lowest marginal rate of tax (increasing under the graduated rate schedule), rather than being *"stacked"* on top of your other income in the year of death, which is likely in a higher tax bracket. Furthermore, some personal tax credits can be claimed on both your regular return and the separate rights and things return, further reducing your tax bill on death. ■

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