Manulife

WEALTH TRANSFER STRATEGY 9

Minimizing taxes on death

Nobody likes to think about their death and who wants to pay more tax than they have to? But, with a little planning you can minimize the taxes your estate might pay at death and ensure a smoother transition of your assets to your loved ones. Here is a list of eight top strategies to deal with that potential tax bill.

LEAVE ASSETS TO YOUR SPOUSE

If you leave your assets to your spouse[1] or to a spousal trust for that person's benefit, you will manage to minimize taxes on your death. Assets left to a spouse or spousal trust are deemed to be disposed of at the deceased's adjusted cost base (ACB), thereby deferring tax until that spouse (or trust) sells the asset, or until the surviving spouse's death.

A spousal trust is a special structure that allows you to leave assets to benefit your spouse, and leaves the day-to-day control and management of the assets to the trustees (which can include your spouse). In order to benefit from the tax-free rollover at your ACB on death, the trust must have very specific terms (a visit to a tax professional is highly recommended). The trust document must state that the spouse is the only one entitled to the income of the trust while he or she is alive and no one other than the spouse is entitled to the assets (i.e. capital) of the trust during that spouse's lifetime.

Although assets left to a spouse or spousal trust are automatically transferred at their ACB, this does not mean that your estate will necessarily have to choose

[1] Includes a spouse or common-law partner as defined by the *Income Tax Act* (Canada).

the ACB as the transfer price. There may be some situations where your estate may still wish to have the fair market value rules apply, such as a situation where there are unutilized capital losses on the date of death and your estate wishes to trigger some capital gains to offset the losses. An election can be made to transfer assets to a surviving spouse or spousal trust at fair market value rather than at the ACB. If assets are transferred to your spouse or spousal trust at fair market value, this will become the ACB for future capital gain or loss calculations.

GIVE ASSETS AWAY

Since you are deemed to have disposed of assets you own at the time of your death, it stands to reason that if you actually dispose of assets before your death your estate will avoid the potential tax bill on death. If you know to whom you want to leave certain assets, and will not have to use those assets to fund your day-to-day living, you might consider giving those assets away during your lifetime.

Although giving assets away is generally considered a disposition for tax purposes, and therefore could give rise to a tax bill if the fair market value at the time the asset is gifted is greater than its ACB, there can still be tax savings by using this strategy. In order for this idea to work, you will want to be sure that the asset you are giving away is likely to grow in value in the future or you will be in a lower tax bracket in the year the gift is made than the year of death.

CHOOSE BENEFICIARIES CAREFULLY

Some individuals wish to leave some assets to their spouse, but also wish to leave assets to other heirs as well. In these situations it is very important to choose the beneficiaries of particular assets very carefully. Since assets left to a spouse can avoid the fair market value disposition on death, you may want to leave assets that have appreciated in value to your spouse first, if you can.

If you're going to leave assets to others, it's best to leave tax-friendly assets such as cash, Guaranteed Interest Contracts (GICs), money market funds, or assets that have not greatly appreciated in value, since the deemed disposition of these assets at fair market value won't lead to a large tax bill anyway.

For assets flowing through your estate, since you may not know today which assets should be left to which beneficiaries, you may simply want to provide your executor with the ability to make that decision after consulting a tax professional upon your death.

MAKE THE MOST OF EXEMPTIONS

There are certain tax exemptions available that could help to greatly minimize a tax bill on death. Speak to your executor and/or tax advisor today to ensure that these exemptions will be taken advantage of when filing your final tax return:

Principal residence exemption: This exemption can be used to offset the capital gains on the disposition (or deemed disposition in the case of death) on one property you own. This could be your home, but it could also be a cottage or other second property that you ordinarily inhabit (rental properties do not qualify).

Lifetime capital gains exemption: This exemption can offset up to $800,000 (indexed for inflation after 2014) of capital gains resulting from the disposition or deemed disposition of your shares in certain private companies in Canada or a qualifying farm or fishing property. There are a lot of tests to meet to claim this exemption, so speak to your tax advisor.

TRACK YOUR ACB

At the time of your death, the difference between the fair market value of capital assets and your ACB is your capital gain, which is subject to taxation. If you can justify as high an ACB as possible, you will help to minimize your estate's tax bill. The problem is that many people don't know how to properly calculate their ACB – they simply assume that it is their original purchase price. Although the purchase price is generally a starting point, there are a number of events and transactions that can take place over the years that could alter the ACB.

Ensure you keep track of the events and transactions, which will impact your ACB, so that your executor can properly report your capital gains on death (you may need the help of your tax advisor with some of these):

- Purchases of the same security over time at different values
- 1994 capital gains elections to "bump up" the cost base of certain assets
- Inherited or gifted assets
- Reinvested distributions from mutual funds or reinvested dividends from stocks

GIVE TO CHARITY

Giving to charity is a great way to help a good cause while receiving a tax break. If you give to charity on your death (usually via your will), your estate will be able to claim a donation tax credit for the fair market value of the gift on your final tax return[2]. If you give assets other than cash, your estate may still have to report a capital gain (or loss) resulting from the deemed disposition rules, however, the donation tax credit your estate receives will offset that gain. More recently, changes have been made that now allow for the donation of marketable securities to charity with no capital gains inclusion on your tax return. See Charitable Giving – The Facts (MK1485E) for more information on giving to charity.

FILE MULTIPLE TAX RETURNS

In the year of death there are four tax returns that can potentially be filed, and filing more than one could save your estate some tax in your year of death. Here are the four potential tax returns:

1. Final, or terminal return. This is your regular tax return that reports regular income plus income accrued from January 1 to your date of death.
2. Return for rights or things. This is an optional tax return that includes income earned and receivable at death, but not yet received. Examples of income included on this return are accrued vacation pay or dividends declared but not paid as of the date of death.
3. Return for income from a testamentary trust. This optional return can be filed if the deceased was the beneficiary of a testamentary trust and more than 12 months' worth of trust income would otherwise have to be reported on the deceased's final tax return.
4. Return for a partner or sole proprietor. This optional return can be filed to report business income of the deceased if the business has an off-calendar year end and more than 12 months' worth of business income would otherwise have to be reported on the deceased's final tax return.

Why would your estate want to file multiple tax returns? Well, for one, a claim can be made for some personal tax credits, such as the basic personal amount, on each of the returns filed on your behalf, effectively multiplying the number of credits claimed in the year. In addition, by spreading your income out over several tax returns, your estate benefits from the lower graduated tax rates more than once in your year of death. Usually the help of a tax advisor should be sought to file the terminal and optional returns since the rules can be complex.

[2] Note, commencing in 2016, the rules relating to donations at death will be changing. The donation receipt in these situations will only be eligible to be used to offset income in the year of death (or the preceding year) if the gift is considered to have been made by the deceased's graduated rate estate.

BUY LIFE INSURANCE

Once you've done all you can to minimize your tax liability on death, you may want to consider life insurance to help fund your estate's eventual tax liability. By purchasing life insurance, you can be assured that your heirs will be left with as much of your estate as possible, and that your assets will not have to be liquidated in order to pay your estate's tax bill. This is especially true where you may have heirs that will depend upon your inheritance to assist with their day-to-day living expenses. Life insurance proceeds is an alternative to having to liquidate assets such as the family cottage to meet dependents' financial needs.

IDEAL CANDIDATES

Individuals with assets that will attract taxes on death who want to:

- Understand the income tax implications on death related to those assets
- Minimize or reduce their estate's income tax bill on death and leave more assets to their heirs

TAKE ACTION

If this applies to you, then:

- Review those assets that may present tax planning opportunities
- Consider one or more of these strategies to reduce tax on death
- Review your estate plan with a tax or legal advisor

FOR MORE INFORMATION CONTACT YOUR ADVISOR OR VISIT MANULIFE.CA/INVESTMENTS

MK2432E 03/2015