**Introduction**

As most readers are aware, the Income Tax Act (the "Act") provides a variety of rules concerning the taxation of capital property held at death. This Tax Topic provides an overview of these rules.

**Non-Depreciable Capital Property**

The most common types of non-depreciable capital property are shares of a corporation, partnership interests and land. Units in a mutual fund or segregated fund would also fall under this category.

Upon death, a taxpayer is deemed under paragraph 70(5)(a) of the Act to have disposed of all non-depreciable capital property for proceeds equal to their fair market value immediately before death. Any resulting capital gain must be reported in the taxpayer's income tax return for the year of death (terminal return). One half of such gains will be added to the taxable income of the deceased individual.

An exception to this rule applies where the capital property in question passes to the deceased's spouse or common-law partner or a "spouse trust". In this situation the transfer takes place at the adjusted cost base (ACB) of the property and the capital gain is deferred until the spouse or common-law partner dies or the property is disposed of by the spouse or common-law partner or spouse trust (subsection 70(6) of the Act). A spouse trust that qualifies for a tax-free rollover of property upon death is a trust where only the surviving spouse or common-law partner is entitled to its income and access to its capital until his or her death. For a further discussion on planning with a spouse trust see the Tax Topic: "Trusts as a Planning Tool".

If the deemed disposition results in a capital loss rather than a capital gain, the loss must first be used to offset the deceased's capital gains in the year of death. Then the losses must be reduced by the amount of any capital gains exemption claimed by the deceased in all previous years. If there are excess capital losses, then a deduction will be permitted against other income in the year of death or in the previous year (subsection 111(2) of the Act). This represents some relief for deceased taxpayers since capital losses are generally only permitted to be deducted against capital gains and not against other types of income.

**Depreciable Capital Property**

Depreciable capital property includes buildings owned for rental purposes by the deceased taxpayer and equipment used in an unincorporated business. As with non-depreciable property, tax deferral is available where such property passes to the deceased's spouse or a spouse trust. Otherwise the taxpayer is deemed to have disposed of the property for proceeds equal to its fair market value immediately before death (paragraph 70(5)(a) of the Act).

Consider the example of a rental property which has an ACB of $100,000 (excluding the value of the land which is capital property), an undepreciated capital cost (UCC) of $80,000 and a fair market value at the time of death of $200,000. Where no spousal rollover is available, the deemed proceeds on death will equal the fair market value ($200,000). The
amount by which the deemed proceeds exceed the ACB ($100,000) would be treated as a capital gain and taxed as described previously. The difference between the property's ACB and its UCC ($100,000 - $80,000 = $20,000) would be treated as recaptured depreciation and would be fully taxed in the year of death.

If the deemed proceeds exceed the UCC but are less than the ACB, the deceased would incur recaptured depreciation but no capital gain or loss. Where deemed proceeds are less than UCC, a terminal loss would be incurred which could be used to offset other income in the year of death.

**Capital Gains Exemption**

Capital gains realized in the year of death may qualify (subject to the rules discussed below concerning real property) for the capital gains exemption. Briefly, individuals are entitled to a maximum exemption of $500,000\(^1\) for most types of farm property as well as shares of qualifying small business corporations. (Formerly, an exemption of $100,000 was available for other capital property. The maximum which any taxpayer could claim in respect of all types of property is $500,000.) Any portion of the exemption which is unused during a taxpayer's lifetime may be utilized in respect of capital gains realized upon death.

The availability of the capital gains exemption at a taxpayer's death leads to a number of planning opportunities:

(i) The traditional spousal rollover, described previously, will not be advantageous where the deceased did not fully utilize his or her $500,000 capital gains exemption before death. In these circumstances, it would be appropriate to consider the election available under subsection 70(6.2) of the Act. It provides that the deceased's personal representative may elect that the normal rollover rules will not apply where property passes to a spouse or common-law partner or spouse trust. Thus the personal representative may transfer sufficient property at fair market value to allow the deceased to realize the amount of capital gains necessary to maximize any unused exemption; the spouse or common-law partner will also receive a corresponding increase in the ACB of the property. Any remaining property can then be transferred using the spousal rollover provisions. With this in mind, it is important that individuals provide in their wills that their executors have the power to make elections under the Act.

(ii) Similar results may be achieved using a "tainted" spouse trust, i.e. a trust where someone other than the spouse or common-law partner (a child, for example) has the right to capital or income during the spouse's (or common-law partner's) lifetime. Property will pass to such a trust at fair market value. Therefore, an individual may provide the executor with the power to transfer sufficient property to a tainted spouse trust so as to allow the utilization of any remaining capital gains exemption. Any remaining property may then be transferred to the spouse or common-law partner or an "untainted" spouse trust, utilizing the spousal rollover rules.

(iii) It is important to note that the $500,000 capital gains exemption is normally available only to individuals. However, under subsection 110.6(12) of the Act, the exemption is made available with respect to property held in spouse trusts in the year of the spouse's (or common-law partner’s) death. Therefore, to the extent that the deceased spouse or common-law partner had not used up their exemption, capital gains realized in the spouse trust on his or her death may be sheltered by using the spouse's (or common-law partner’s) exemption.

\(^1\) The 2007 Federal budget proposed to increase the capital gains exemption to $750,000 for dispositions on or after March 19, 2007. As of July 2007 the changes are still proposed. This Tax Topic will be updated when the legislation has been written and received Royal Assent.
**Alternative Minimum Tax (AMT)**

Individuals who incur significant amounts of exempt capital gains during their lifetimes may be subject to AMT. However, under section 127.55 of the Act, AMT will not apply in the year of a taxpayer's death. (For more detail refer to the Tax Topic "Alternative Minimum Tax and Tax Preference Items")

**Payment of Tax**

In many cases, the deemed disposition rules described above cause significant tax liabilities in the year of death. For estates with liquidity problems, some relief is available under subsection 159(5) of the Act by filing form T2075. Under this provision, income taxes owing for the year of death may be paid in annual instalments (not exceeding ten) with interest charged at the prescribed rate from the day taxes should have been paid. This interest would not be incurred for the purpose of earning income and would therefore not be tax deductible.

If taxes owing by a deceased individual are to be paid by instalment, security must be provided to the Minister. This may be in the form of a charge on property owned by the deceased or by another person, or a guarantee provided by another person.

It is therefore critical in the estate planning process to ensure that there is sufficient liquidity for the payment of taxes and other debts. The planner’s goal should be to ensure that the estate does not become subject to long term liabilities to CRA and to avoid the forced sale of property (perhaps under unfavourable market conditions) simply as a means of acquiring cash to pay debts.

For these reasons, it is generally recommended that life insurance be acquired as a means of funding income tax and other liabilities which are incurred upon death. This is the most effective means of guaranteeing that the required amount of cash will be available exactly when needed.

Where property is being passed on death from one spouse or common-law partner to another, the tax liability may be deferred until the surviving spouse’s or common-law partner’s death. In these circumstances, individuals should consider the acquisition of insurance on the lives of both spouses or common-law partners, with proceeds payable on the second death. This is not only a means of adapting life insurance precisely to the estate plan, but may also be considerably less expensive than purchasing insurance on one life only.
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