RBC Investments

Financial Planning Quick Tip

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SUBJECT: Estate as a Separate Taxpayer

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An estate planning opportunity that is commonly overlooked is the use of testamentary trusts. A testamentary trust is a trust that is commonly created in a person's Will, and that takes effect upon the person's death. The creation of a testamentary trust can provide an income splitting opportunity since a testamentary trust is considered a separate taxpayer for tax purposes. Income earned by the trust can then be taxed in the trust as opposed to the beneficiary of the trust who may already be at or near the top marginal tax rate.

For tax purposes, the estate of a deceased individual is also taxed as a testamentary trust. As such, an executor who is also the sole beneficiary of the estate, and who is at or near the top marginal tax bracket, may be reluctant to wind up an estate where the Will calls for the outright distribution of the estate assets (ie. no testamentary trust created in the Will). By leaving the assets in the estate, the income earned on such assets can be taxed at the estate's graduated rates as opposed to an outright distribution where the income would be taxed at the beneficiary's high marginal tax rate. The question then, is how long can the estate continue to exist as a separate taxpayer?

A reported case that dealt with this issue occurred in 1989 and involved a chartered accountant that was the sole executor and beneficiary of an estate. The Will of the deceased provided for an outright distribution and all estate assets were converted to cash shortly after the testator's death. However, the beneficiary continued to report the interest income earned on the estate proceeds as income of the estate for the next two years. Canada Revenue Agency (CRA) (then known as Revenue Canada) reassessed the beneficiary by attributing the interest income to the beneficiary personally. The Tax Court of Canada upheld CRA's assessment and ruled that the income was taxable to the beneficiary once the beneficiary was entitled, by law, to enforce payment. The Court reasoned that the beneficiary in this case was legally entitled to enforce payment once the administration of the estate was completed, and since the administration of the estate was completed shortly after the testator's death, the beneficiary was thereby taxable on the income for both years.

The Court's decision has raised some concerns in the legal community. This is because there is a long established common law principle that essentially says a beneficiary can not enforce payment during the first 12 months period following the deceased's death. This period, commonly referred to as the executor's year, is the period traditionally allowed to an executor to settle an estate. The Court's decision may further be inconsistent with CRA's own administrative positions. Paragraph 5 of Interpretation Bulletin IT-286R2 states that even where a beneficiary can enforce payment from a trust, it is the Department's (CRA) view that no amount becomes payable until such time as the beneficiary exercises the authority and in fact causes the trust to be wound-up. Paragraph 6 of the same Interpretation Bulletin provides that for the executor's year, income of the estate will be taxed in the estate upon the request of any beneficiary.

Until further clarification is provided by the courts or by CRA, a cautious approach may be that as long as there is a legitimate reason why administration of the estate has not been completed, income earned in the estate during this period can continue to be taxed in the estate.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with your advisor.