Filing the T3 tax return

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Most executors know that completing a final tax return for the deceased is a core duty. But some are surprised to hear they may need to file a return for the estate itself—the T3 Statement of Trust Income. What is the T3, and how does an executor file it properly?

The estate as a trust

Ken Michalak, an accountant in Toronto, acknowledges that filing a T3 isn't the easiest job. But understanding the principles behind it may help an executor.

"An estate is considered a trust: an arrangement in which the trustee holds property for the benefit of one or more beneficiaries," Michalak explains. "And a trust is considered a taxpayer—an individual—under the Income Tax Act, so it must file a tax return. Basically, that's what the T3 is: a special return for a trust."

Much like a taxpayer would report annual income, so too must every estate, starting on the day after the testator's death, and continuing until all estate assets pass to beneficiaries. As Michalak points out, that could be a long time, particularly if the estate is complex or subject to legal challenge. He recently resolved one that had been going on for 10 years, he notes.

Much like a T1 return for an individual, the T3 must include basic information about the taxpayer (i.e., the estate itself). This includes the trustee or executor's address, the social insurance number of the deceased, the date of death, beneficiary information and a valuation of estate assets included on the deceased's final T1.

One key difference: the filing date. For individuals, the tax year is the same as the calendar year, and the T1 is due April 30 for deaths before Nov. 1; it's due six months after death for deaths from Nov. 1 to Dec. 31. With an estate, the tax year starts the day after the testator's death and can continue for 12 months if the estate is a Graduated Rate Estate (see next section) or until Dec. 31 for all other trusts. The T3 needs to be filed 90 days after the trust's year-end. For Dec. 31 year-ends, that makes the T3 filing deadline March 31 (March 30 in leap years)—different than the more familiar April 30 deadline.

As Michalak explains, not every estate needs to file a T3. For example, if the estate is wound up and all assets distributed to heirs immediately (e.g., when assets held jointly simply pass to a surviving spouse), it may generate no income and a T3 is not required.

Or, the estate may be simple—a single parent passing on a principal residence and a bit of cash in a chequing account to a single adult child beneficiary, who may also be the executor. In such cases, the executor may skip the T3.

"Quite frankly, it's not worth it," Michalak says. "Mom and Dad had some interest income—rather than going through the expense of doing a T3 trust return, a beneficiary may just report the income on his or her T1 and pay the tax on it." In other words, the executor should ensure either the estate or the beneficiary pays the tax.

Complicated choices

Brent England, partner at Hutcheson & Co., an accounting firm in Victoria, B.C., says executors may face challenging decisions when filing a T3.

"It's a bit more complicated than a T1, in that there [are] several different routes that you can take […] and certain extra elections," England says. "There's a due process to [follow] to make sure the executor doesn't [bring] any liability on themselves."

One of the most important decisions is whether to declare the estate a Graduated Rate Estate (GRE) on the estate's first T3. Such an election allows estate income to be taxed at graduated rates rather than the highest marginal rate (and to have a non-calendar tax year) for a maximum of 36 months after the deceased's death.

England says this election could end up generating significant tax savings for heirs who are taxed at the highest marginal rate. "Most estates will want to do this."

Another important decision: the election to declare income within the trust. "Depending on the tax rate of the individuals getting the income and the tax rate of the trust, you may choose to do it or not," England says. Again, this decision has important implications for the amount owed to CRA. For example, if the beneficiary is at a high marginal tax rate, it makes sense to tax income within a GRE. On the other hand, if the estate has enough income to push it into a high marginal rate, it may make sense to flow some of that income to a beneficiary who's taxed at a lower rate. The election could change from year to year, depending on the estate's circumstances and as long as the will lets the executor or trustee determine whether the income is taxed in the hands of the GRE or distributed to beneficiaries.

If the executor makes the wrong decision, heirs could pay thousands more in tax, which could expose the executor to personal liability. "If you're the sole beneficiary and the sole executor, maybe it doesn't make that much difference," he says. "But if you've got a couple of siblings involved […] then it's a pretty big deal."

What income should be reported on a T3?

- **Interest earned** on cash held in bank accounts, bonds, GICs, Treasury Bills and similar securities
- **Dividends received** on stocks, mutual funds or other securities
- **Business or farming income** generated before shares are distributed to heirs or a farming property is sold
- **Capital gains on property** that has risen in value between the date of death and the day it is eventually sold or passed to beneficiaries
- **Rental income** generated by renting the principal residence, cottage or other real estate before distribution or sale

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