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Common wealth transfer mistakes[1]

TRS | TAX & RETIREMENT SERVICES

WEALTH TRANSFER STRATEGY 6

Quebec edition

Each year in Canada, billions of assets are transferred at death. If you intend to transfer all, or part of, your assets to your heirs you want to make sure that they go to the people you selected and in the manner you intended. Unfortunately, the wealth transfer does not always occur as planned. Outlined below are some common mistakes that can occur when trying to transfer wealth.

FAILING TO HAVE A WILL

A basic and all too common mistake is failing to have a will. A will communicates your intentions and allows you to determine how your assets will be distributed upon your death. In the absence of a will, your property will be distributed on your death according to the legal devolution provided under the Civil Code of Quebec. Having a will facilitates the liquidation of your estate and can include tax planning to reduce taxes on death. It also allows you to choose the liquidator of your estate, the trustee of your testamentary will and the tutor(s) of your children.

For more information on wills see Wealth Transfer Strategy #5 (MK2263).

WILL DRAFTING ERRORS

Having a properly drafted will is important, to say the least. Set out below are a few things to consider that you might not be aware of.

If you are thinking of using a handwritten will (also known as a holograph will) or a will made in the presence of witnesses be wary. Often, there may be problems with interpreting one's instructions if they are not clear or they may not comply with the formalities of the Civil code of Quebec. Such issues may invalidate the will or add costs to the liquidation of the estate and delay distributions out of the estate. Having a will prepared by a legal advisor is always preferable to both holograph or a will made in the presence of witnesses.

[1] The content in this article is specific to residents of Quebec. Individuals should consult with their legal advisor. For all other provinces, please refer to MK2269.

Furthermore, a Quebec resident that has a notarial will can eliminate substantial costs and delays in the settlement of their estate as this form of will does not have to be probated by the Superior Court.

If you make a donation in your will and you leave too much discretion to the liquidator in choosing a charity or the amount of the bequest, the Canada Revenue Agency (CRA) may allege the gift is made by the estate and not deemed to have been made by the deceased in the year of death. This means the charitable tax credit can only be claimed on the estate's tax return and not on your terminal tax return.

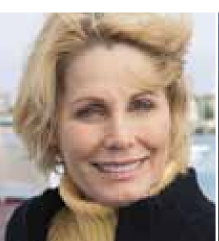
In Quebec, a marriage or a civil union does not revoke a previous will, however a divorce, marriage annulment (not a separation as to bed and board) or the dissolution of a civil union will void any legacy made in favor of the former spouse as well as the designation of the spouse who has been designated as liquidator of the estate if such designation was made prior to the date of divorce, annulment or dissolution.

Gifts or inheritances to one of the spouses either before or during the marriage or civil union are excluded from the family patrimony, and will not be included in its partition upon a marriage breakdown. During the marriage or civil union, the income from an inheritance or gift may also be excluded from the family patrimony. However, this may be jeopardized if the recipient uses the gift for the benefit of the family or commingles the assets with other family assets so it can no longer be traced. Special attention must be given in the drafting of the will, for any potential impact on the family patrimony and in particular, other matrimonial regimes.

TREATING EQUAL BENEFICIARIES UNEQUALLY

Often when splitting assets, the intention is to split them equally between beneficiaries, for example, equally between three children. However, if you fail to take into account the tax consequences, the wealth transfer may not be equal. Take the simple example where you have three assets; a Registered Retirement Savings Plan (RRSP), a home and a non-registered mutual fund portfolio, and each asset is worth $1 million. You name your first child as beneficiary of your RRSP (assuming your RRSP is invested in a product which allows a beneficiary designation), and in your will you leave the house to your second child and the rest of the estate, namely your mutual funds, will go to your third child. You think you are leaving $1 million to all three, but the reality is the third child who is receiving the mutual funds under the will is going to have their share reduced by any tax your estate pays on the RRSPs and the mutual funds.[2] Assuming a 40 per cent effective tax rate, your estate would pay $400,000 in taxes on the RRSPs, in addition to any potential taxes on the deemed disposition of the mutual funds which we'll assume are $100,000. As a result, the third child responsible for the tax liability would be left with $500,000, significantly less than the $1 million the first and second child each received, and not what you had intended.

[2] It is assumed that the home can be transferred tax-free as a result of the principal residence exemption.



SPOUSAL ISSUES

Another example of failing to consider the tax implications often involves second marriages or separated and estranged spouses. For example, you have named your new spouse as beneficiary of your RRSP (assuming your RRSP is invested in a product which allows a beneficiary designation) or Registered Retirement Income Fund (RRIF) (again, assuming your RRIF is invested in a product which allows a beneficiary designation) to provide for them after your death, and named your children (perhaps from a previous marriage) as beneficiaries under your will to inherit the rest of your estate. You assume that your spouse will roll over your RRSP or RRIF to their RRSP or RRIF, and pay tax on any withdrawal. But what if they don't? Instead, because he or she is also the liquidator, he or she just takes the cash. Well, your estate could be responsible for any taxes on the RRSP or RRIF which effectively means it comes out of your children's inheritance.

Under these circumstances, there are two strategies that can be utilized to prevent this from happening:

1) It is possible that the legal representative (liquidator) of the estate to make a unilateral election to deduct the amount paid from the RRSP or RRIF in the estate. By doing so, this limits the tax burden in the estate and shifts the income inclusion to the surviving spouse. You may have to choose someone else than the spouse as the liquidator or you could order your liquidator to make the said unilateral election (you could ask your notary to write the appropriate provision in the will).

2) If you have a RRIF, and the contract allows, consider naming your spouse as successor annuitant. On your death, the RRIF will automatically transfer to your spouse on a tax deferred basis ensuring that your estate will not have to pay the tax. For second marriage situations where you want to provide an income stream to your spouse but want to ensure that anything left in the RRIF on your spouse's death goes to your children, see Wealth Transfer Strategy #2 (MK1919).

FAILING TO UPDATE BENEFICIARY DESIGNATIONS

When a life event such as a birth, death, marriage, separation or divorce occurs people often remember to review and update their will accordingly but may forget to review their beneficiary designations. Make sure you review your will and any beneficiary designations to make sure that these still reflect your testamentary intentions. This is a common oversight and often results in the courts having to decide.

[3] The Joint Life Payout Option is a guaranteed income stream based on the lives of both the annuitant and the Joint Life, which must be the spouse of the annuitant. Only one person can be named as the Joint Life and may not be changed.

MINOR BENEFICIARIES

It is important to consider the age of the individuals you name as beneficiary. Remember that although there are exceptions, a minor generally does not have the legal capacity to enter into a contract and that he or she will be represented by his or her parents acting as tutor until the minor child reaches the age of majority.[4] In addition, once a minor reaches the age of majority he or she will be entitled to the funds, without any restrictions unless you provide otherwise.

Naming a minor as irrevocable beneficiary is even more problematic and should almost never be done. When an irrevocable beneficiary is named, their consent is required to deal with the contract. However, a minor cannot provide their consent until they reach the age of majority which means the contract will effectively be frozen until that time. Furthermore, as explained above, a death benefit paid to a minor will be administered by his or her tutor.

A trust can also be created in a will for the benefit of a minor child. Also, in a simpler will, a wider range of powers can be granted to the liquidator of the estate. The trust document can set out how you want the funds to be invested and when payments are to be made for the benefit of a minor. If done properly, it could qualify as a testamentary trust and benefit from being taxed at the graduated tax rates.[5]

LUMP SUM TO ADULT BENEFICIARIES

Sometimes providing a lump sum payment to adult beneficiaries is not wise. This could be the case if the beneficiary is not financially responsible and may spend the money frivolously or perhaps is disabled and may lose their government disability benefits. For these individuals, an annuity settlement option or testamentary trust may be more appropriate. For more information see "Protecting your nest egg after you're gone" (MK1670) and Wealth Transfer Strategy #4 (MK2145).

FAILING TO NAME A BENEFICIARY OR NAMING ONE'S ESTATE AS BENEFICIARY

Naming a beneficiary in an insurance investment (such as a segregated fund contract) may save some time and costs. However, naming a beneficiary may also cause some tax issues that have to be well understood and taken into consideration in the overall planning (See previous example under Treating equal beneficiaries unequally). These issues will arise whenever the beneficiary in the contract is different from the heirs of the estate.

There might be some specific reasons for having assets flow through your estate, such as to make use of tax losses or deductions or to apply any special instructions contained in the will. If you wish to leave assets to people that need supervision such as young children and that you would want to leave special instructions for the use of the money or the timing in the delivery of the bequest, then you should consider naming the estate as beneficiary and have a will properly addressing these issues and name a trusted person to take over the administration of this legacy.

Having assets flow through your estate may subject them to claims by your estate creditors and incur some administration fees. There is also the potential risk of having your will or the estate settlement challenged in court and having this asset frozen during the dispute. When any beneficiary is named, the asset should be excluded from your estate granting protection against the creditors of your estate. Also, if an appropriate beneficiary designation is made[6], or a beneficiary is named irrevocably (with all related risks of doing so), the insurance investment offers you the potential for creditor protection while alive.

[4] If the last surviving parent is not capable of acting or is dead without appointing a tutor in his or her will, a family counsel with court approval will appoint such tutor. [5] See Wealth Transfer Strategy #4 (MK2145) for more information on insurance trusts. [6] In Quebec, the appropriate beneficiaries we are referring to are the married or civil union spouse, descendants and ascendants of the owner.

UNUSED CHARITABLE DONATIONS

If you are planning on making a significant charitable donation at death, steps should be taken to ensure that your estate will be able to use the entire donation receipt. While the limit for claiming donation receipts at death is 100 per cent of net income in the year of death and the year prior to death, it is still possible for there to be unused receipts. Individuals making extremely large donations relative to their annual income, who die early in the calendar year or who name a charity as beneficiary of their non-registered investments or life insurance policy have a greater risk of having unused charitable tax credits. Leaving an RRSP or RRIF to a charity is usually not a problem because charitable receipts can be used to offset the tax on the income from the RRSP or RRIF. If you have a spouse with sufficient income, they could also claim any unused charitable receipts for the next five years.

If you are concerned that you may have unused charitable receipts at death, consider making some charitable donations while alive and reduce your taxes payable now.

IDEAL CANDIDATES

Individuals who want to:

- Transfer assets to their heirs
- Ensure their assets are distributed according to their wishes
- Avoid making one of the common mistakes outlined earlier

TAKE ACTION

If this applies to you, then:

- Have a will prepared by your notary or lawyer (if you don't already have one)
- Review your estate plan, including your will, beneficiary designations and jointly held property with your tax or legal advisor
- Review your will and beneficiary designations regularly and after a life event to ensure they still reflect your wishes and amend or update them if need be

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