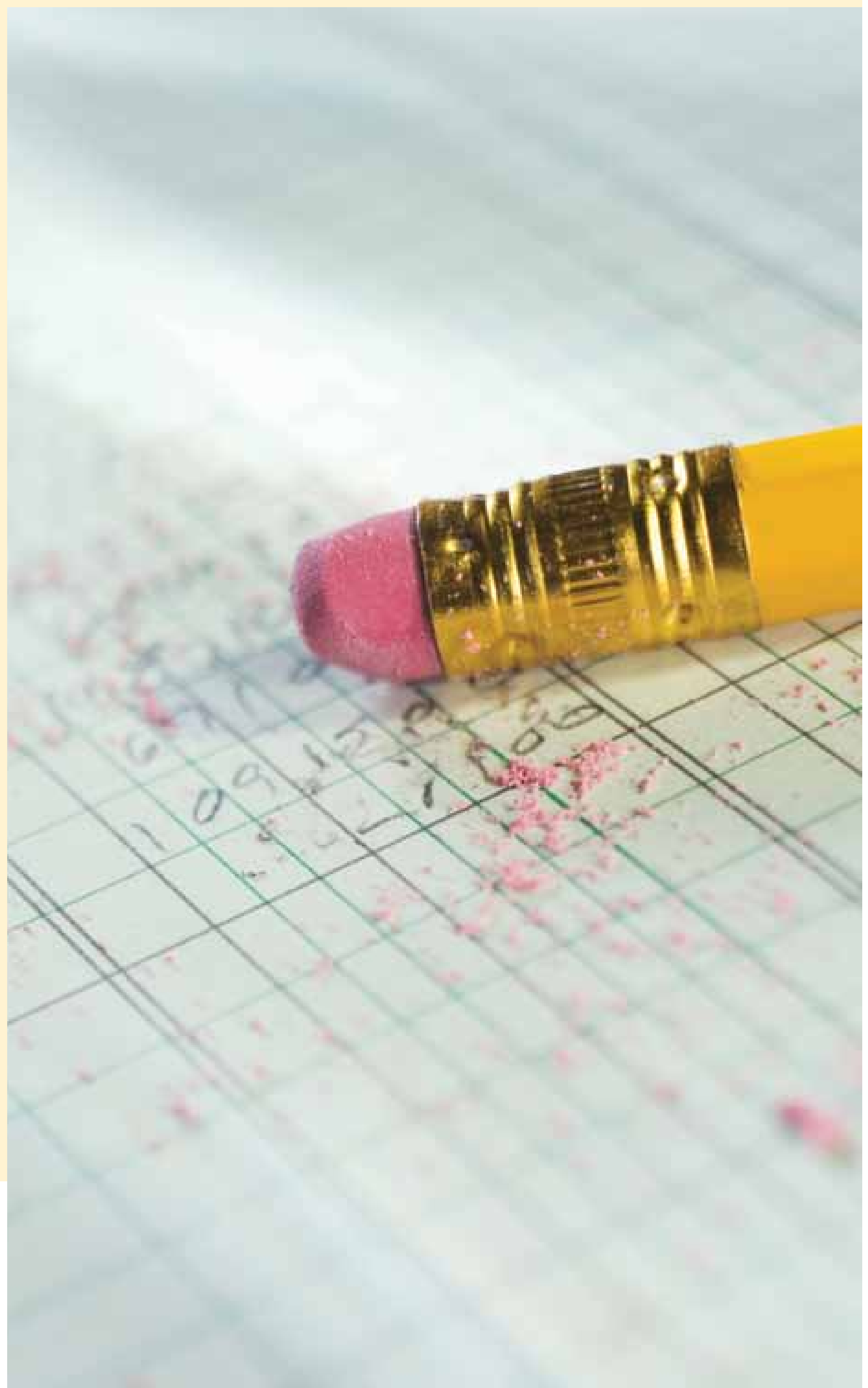
COMMON WEALTH TRANSFER *mistakes*[1]



The importance of planning for a wealth transfer

Each year in Canada, billions of dollars in assets are transferred at death. If you plan to transfer all or some of your assets to your heirs, you want to make sure your money goes to the people you selected in the manner you intended. Unfortunately, wealth transfers don't always occur as planned. Outlined below are some common mistakes people make 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 – and not the government – to determine how your assets will be distributed upon your death. Having a will facilitates the administration of your estate and can help you save taxes. It also allows you to choose the executor of your estate and the guardian(s) of your children.

TREATING EQUAL BENEFICIARIES UNEQUALLY

Often, when splitting assets, the intention is to divide them equally among beneficiaries – for example, equally among three children. However, if you fail to take into account the tax consequences, the wealth transfer may not be equal. Take a simple example in which you have three assets: a Registered Retirement Savings Plan (RRSP), a home and a non-registered mutual fund portfolio. Each asset is worth $1 million. You name your first child as beneficiary of your RRSP, and in your will you leave the house to your second child and the mutual funds to your third child. You think you are leaving $1 million to each child, but the reality is that the third child, who is receiving the mutual funds under the will, is going to have his or her share reduced by any tax your estate pays on the RRSP and the mutual funds.[2] Assuming a 40 per cent effective tax rate, your estate will pay $400,000 in taxes on the RRSP, 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 will be left with $500,000 – significantly less than the $1 million the first and second child each received, and not what you had intended.

SPOUSAL ISSUES

Another example of failing to consider the tax implications often involves second marriages or separated and estranged spouses. For example, let's say you name your spouse as the beneficiary of your RRSP or RRIF to provide for him or her after your death, and you name 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 his or her own RRSP or RRIF, and pay tax on any withdrawals. But what if your spouse doesn't do this? Instead, he or she just takes the cash. Well, your estate will be responsible for any taxes on the RRSP or RRIF, which effectively means that money comes out of your children's inheritance. Under these circumstances, it is possible that the legal representative of the estate to make a unilateral election to deduct the amount paid from the RRSP or RRIF in the estate. This effectively transfers the income inclusion to the surviving spouse. Alternatively, if you have a RRIF, consider naming your spouse as successor annuitant or Joint Life[3]. This will automatically transfer the RRIF to your spouse on a tax deferred basis.

[1]Many of the issues discussed will vary by province. Individuals should consult with their legal advisor. [2]It is assumed that the home can be transferred tax-free as a result of the principal residence exemption. The general rule is that absent a tax-deferred rollover, the fair market value of the RRSP must be included in the annuitant's terminal return and taxed in the estate. [3]The Income Tax Act does not allow an RRSP to name a successor annuitant.

MINOR BENEFICIARIES

It is important to consider the age of the individuals you name as beneficiaries. Remember that generally death benefits cannot be paid directly to minors, so if you name a child as beneficiary the funds often have to be paid into court or to the Public Trustee. In addition, once a minor reaches the age of majority, he or she will be entitled to the funds, without any restrictions.

If you want the death benefit to go to a minor[4], it is recommended that you establish a trust to receive the funds on behalf of the minor.[4] The terms of the trust 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, the trust could qualify as a testamentary trust and benefit from being taxed at the graduated tax rates.

FAILING TO NAME A BENEFICIARY ON INSURANCE POLICIES AND CONTRACTS

Unless there is a specific reason 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, it may be a better idea to name a beneficiary directly on an insurance contract where possible. If your will is submitted for probate, it becomes a matter of public record, available for anyone to view. This may delay the distribution of your estate by weeks, months or even years if your will is challenged.

When a beneficiary other than your estate is named on an insurance policy or investment contract (such as a segregated fund contract), the death benefit bypasses your estate and therefore avoids probate fees (and potentially other estate administration fees). The proceeds are paid directly to the beneficiary, usually within two weeks of receiving all necessary documents. By avoiding your estate, the death benefit may also avoid claims by creditors of the estate and challenges to the validity of the will.

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 investment or life insurance policy,

have a greater risk of having unused charitable tax credits. Naming a charity as beneficiary of an RRSP or RRIF 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, he or she 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 during your lifetime and reduce your taxes payable now.

As you can see, there are many reasons why it is important to plan for a wealth transfer. If you don't have a will, arrange for your lawyer to prepare one. Review your will and beneficiary designations regularly, particularly after a life-changing event, to ensure they still reflect your wishes – and amend or update them as necessary. In addition, meet with your advisor to discuss your wishes for wealth transfer. He or she will be able to help ensure that your assets are distributed as you wish. •

[4]Not applicable in Quebec. Consult your legal advisor for more details.

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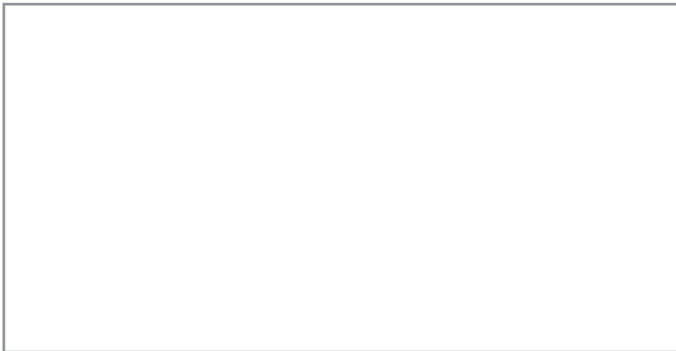

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