STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

Tax Free Savings Accounts

This newsletter replaces Initiative Vol. 12, No. 01 which is obsolete and should not be referenced.

When it comes to naming beneficiaries, Tax Free Savings Accounts ("TFSAs") can be potential minefields as many people misunderstand the distinction between the terms: beneficiary, successor owner and successor annuitant.

Consider the following three situations upon the death of a tax free savings account plan-holder:

1. John is the plan-holder and annuitant. His wife Mary is the successor owner, and their son Bill is the beneficiary, all designated on the application (vs. a will declaration).

Result:

Upon John's death, no proceeds will be paid out to the beneficiary, Bill. John's executor does not include the value of his TFSA account, contributions nor earnings, in John's date of death income tax return.

Mary, his spouse, will become the new holder of the TFSA immediately upon John's death and the financial institution administering his TFSA will handle all of the required documentation and CRA filings. Mary, as the successor holder, will receive John's TFSA assets and all earned income, up to the date of his death, sheltered within a TFSA account.

All of the assets and any earned income after the date of John's death will remain sheltered from income tax within the TFSA.

After taking over ownership of the deceased's TFSA, Mary, the successor holder, can transfer all or a portion of that TFSA account into her own existing TFSA account, without impacting her TFSA contribution room. Mary can make tax-free withdrawals and make new contributions subject to her own unused TFSA contribution room limits.

Mary may also change the beneficiary.

2. John is the plan-holder and annuitant. His wife Mary is the primary beneficiary. A registered charity is the contingent beneficiary.

Result:

Upon John's death, his TFSA assets are no longer sheltered from taxation after his date of death. John's executor does not include the value of his TFSA account, contributions nor earnings, in John's date of death income tax return. Mary, the beneficiary, will receive the date of death fair market value of John's TFSA account free of any taxation.

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The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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Mary can transfer John's TFSA assets into her own TFSA account. All of the earned income and increase in TFSA asset values between the date of John's death and the date of the transfer are paid to Mary as taxable income and must be included in her income tax return.

Mary can contribute a portion or all of John's TFSA assets up to the limit of her own unused TFSA contribution room. In the event that Mary predeceases John, then the registered charity as a Qualified Donee, receives all proceeds.

The transfer of the TFSA assets to the Qualified Donee must occur within 36 months after John's death. In addition, once the transfer has been made and the donation receipt has been received, the executor can request that John's Date of Death Income Tax Return be adjusted in order to claim the charitable donation tax credit.

3. John is the plan-holder and annuitant and his spouse, Mary, together with their son, Bill, are named as beneficiaries.

Result:

Upon John's death Mary and Bill receive the fair market value of John's TFSA as of the date of his death, split up in accordance with any instructions given in the plan.

Mary cannot elect to designate any portion of her share of the fair market value of John's TFSA as of the date of his death as an Exempt Contribution. The Exempt Contribution Election is not available to surviving spouses or common-law partners, named as a beneficiary but not a Successor Holder, in the following instances:

a) For Mary as a survivor beneficiary, to qualify for the Exempt Contribution Election, she must be the sole-beneficiary of the TFSA.

b) At the time of death, the deceased's TFSA included amounts that are classified as excess TFSA contributions.

c) If the survivor payment was made after the Rollover Period, specifically, "the period that begins when the plan-holder dies and at the end of the calendar year that follows the year of death."

Consider whether the results above correctly reflect John's intentions. When there is a named beneficiary and a successor owner, there may be confusion on the death of the original plan holder as to whether the beneficiary gets the money or whether any death benefit guarantees apply. No death benefit guarantees apply on the first death. As a successor plan-holder upon John's death, Mary becomes the owner and annuitant.

Tax free savings accounts are generally passed to their beneficiaries on a tax- free basis. Specifically, the fair market value of the tax free savings account as of the date of the death of the plan-holder can be passed on them tax-free. Any growth between the date of death and receipt of monies is taxable to the beneficiaries. A beneficiary can be a spouse, common-law partner or anyone else named to inherit the plan's assets — children, siblings, relatives, friends or a charity. To continue with tax-free growth after death, contribution room is normally required unless a spouse or common-law partner (collectively known as spouse) receives the asset.

Where a spouse is concerned, to ensure a smooth transition of the tax free savings account is to name him/her as a successor owner which is different from a beneficiary. A successor owner can only be the spouse of the plan-holder.

As the successor owner/holder (subrogated policyholder in Quebec) the spouse essentially steps into the deceased's shoes as the owner. Any reset or maturity features, benefits and timelines are preserved, uninterrupted. The recipient spouse does not have to have any contribution room in his/her own tax free savings account to absorb the new funds. The recipient's future contribution room is also unaffected.

Naming a spouse as a beneficiary still allows for a transfer of funds to his/her existing tax free savings account without requiring or affecting his/her contribution room.

The "exempt contribution", the fair market value (FMV) of the deceased plan-holder's account, is a tax-free funds transfer that must be deposited to the spouse's tax free savings account by the end of the year following the date of death of the plan-holder. In addition, the spouse as sole beneficiary must file Form RC240 with Canada Revenue Agency (CRA) within 30 days after the transfer has been made.

The decision to name a successor owner, annuitant or beneficiary on a tax free savings account does not affect the tax treatment upon death to the plan-holder, but can have an impact on the taxation beyond the date of death of the plan-holder.

The disadvantage of naming a spouse as a beneficiary is that all income earned inside the tax free savings account, as well as any increase in fair market value of the tax free savings account assets, from the date of death until the date the funds are is paid out to the spouse's plan, will be taxable as ordinary income to the spouse.

Where tax free savings account assets include Empire Life Segregated funds, it is important to consider the protection of market down turns with the death benefit guarantees on the segregated funds. The death benefit guarantee is either 75% or 100% of net deposits. On death, the beneficiary is guaranteed to receive the greater of either 75% or 100% of his/her net deposits or the market value of the segregated fund investments. In addition, benefit guarantees can be reset depending on the guarantee available. If the market value of the segregated fund investments is higher than the net deposits, death benefit guarantees can be reset based on the higher value.

If the recipient spouse is a successor owner, not a beneficiary, the spouse will not be able to capitalize on the death benefit guarantees provided by the segregated fund.

As you approach clients to discuss tax free savings accounts, do not forget to address their estate-planning needs and priorities. This will help ensure that the plans are addressed appropriately and your client's intended results upon death will be executed. You never know, it may lead to larger estate planning discussions as well, something every client should consider.