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Common wealth transfer mistakes[1]

WEALTH TRANSFER STRATEGY 6

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 it goes 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 – 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. For more information on wills see *Wealth Transfer Strategy #5* (MK2264).

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 do-it-yourself will (also known as a stationary will), be wary. Often, there are problems with interpreting one's instructions if they are not clear, or they may not comply with provincial statutory requirements. Such issues may invalidate the will or add costs to the administration of the estate and delay distributions out of the estate. Having a will prepared by a lawyer is always preferable to both holograph and stationary wills.

[1]This Wealth Transfer Strategy applies to all provinces other than Quebec. For Quebec residents, refer to Common Wealth Transfer Mistakes (Quebec edition) MK2267. Many of the issues discussed will vary by province. Individuals should consult with their legal advisor.

In some provinces (e.g. Ontario), one strategy used to avoid probate fees is to have multiple wills where one will is submitted for probate, and another will (dealing with assets which do not require probate) is not. Shares of a private corporation are a common example of an asset that may avoid probate fees through the use of multiple wills.

If your will leaves too much discretion to the executors 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 be made 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 return.

In most provinces other than Quebec, marriage revokes a will unless the will specifically contemplates the marriage and identifies the future spouse.

In many provinces gifts or inheritances are excluded from equalization upon a marriage breakdown. In fact, in some provinces the income from an inheritance or gift can also be excluded if the will expressly says so. If this is the case, make sure your will has the appropriate declarations. However, this may be jeopardized if the recipient uses the gift for the benefit of the family, contributes the money to a matrimonial home or commingles the assets with other family assets so it can no longer be traced.

TREATING EQUAL BENEFICIARIES UNEQUALLY

Often when splitting assets, the intention is to split them equally between beneficiaries, for example, between three children. However, if you fail to take into account the tax consequences, the wealth transfer may not be equal at all. 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, 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 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 would be left $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. 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. See Wealth Transfer Strategy #8 (MK2417) for more information on the taxation of RRSPs and RRIFs at death.

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 or Registered Retirement Income Fund (RRIF) 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, 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 (executor) 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.
2) If you have a RRIF, and the contract allows, consider naming your spouse as successor annuitant or Joint Life[3]. 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 they still reflect your testamentary intentions. This is a common oversight and often results in the courts having to decide.

MINOR BENEFICIARIES

It is important to consider the age of the individuals you name as beneficiary. Remember that generally death benefits cannot be paid directly to minors and therefore will 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.

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 earlier, a death benefit could not be paid directly to them while a minor.

[3]The Income Tax Act does not allow an RRSP to name a successor annuitant.

If you want the death benefit to be paid to a minor, it is recommended that a trust be used to receive the funds on behalf of the minor. 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.[4]

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

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 a contract where possible. Having assets flow through your estate may subject them to claims by your estate creditors and/or probate and administration fees. Furthermore, if your will is submitted for probate, it becomes a matter of public record, available for anyone to view.

When a beneficiary other than your estate is named on an insurance investment (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 then paid directly to the beneficiary, usually within two weeks after 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 which can delay the distribution of your estate by weeks, months or even years. Also, if a beneficiary of the family class[5] is named or a beneficiary is named irrevocably, the insurance investment offers you the potential for creditor protection while alive.

ADDING A JOINT OWNER OTHER THAN YOUR SPOUSE

Placing non-registered assets into joint ownership with right of survivorship[6] is one of the most common methods of avoiding probate. On the death of one joint owner, the asset transfers directly to the survivor bypassing the deceased's estate. However, there are some significant disadvantages with joint ownership, particularly when someone other than your spouse is added as joint owner.

For example, you are single with two adult children. Your daughter lives in town and your son lives on the other side of the country. Your health is failing and your daughter is caring for you. To help her to take care of you, you add your daughter as joint owner to your bank and investment accounts which are your only assets.

[4]See Wealth Transfer Strategy #4 (MK2145) for more information on insurance trusts. [5]In provinces other than Quebec, a family class beneficiary is any of the spouse, child, grandchild or parent of the annuitant. In Quebec it is any of the spouse, descendants and ascendants of the owner. [6]All other references to joint ownership mean joint ownership with right of survivorship. Joint ownership does not apply in Quebec.

Your intention, as per your will, is to divide your estate equally between your kids. On your death the accounts automatically transfer to your daughter. If your daughter is not honest and doesn't return the funds to your estate there is nothing left for your son and will probably result in a lawsuit. The court will try to determine your intention. Was this a gift to the daughter or merely an agency agreement? That is why it is so important that you document your intentions so the courts can administer your estate according to your wishes. Your other alternative is to make sure you have a properly executed Power of Attorney for property which could allow your child to assist in administering your finances without having to add them as joint owner.[7]

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, 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.

[7]See Wealth Transfer Strategy #3 (MK1973) for more information on the risks of joint ownership.

IDEAL CANDIDATES

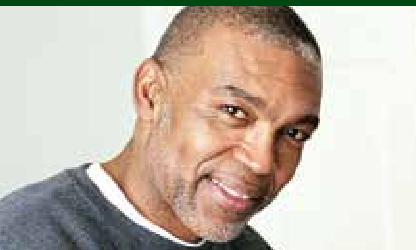
Individuals who want to:

- 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 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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