

TFSA's – an RRSP season opportunity

A look at participation rates and estate planning implications

\$ tax talk

Participation: Most Canadians aren't there yet

Tax-Free Savings Accounts (TFSA's) have been around for a year now, and while many are excited about the benefits they provide – namely flexibility and tax-free growth – several polls suggest the participation rate among eligible Canadians is approximately 25%. A poll sponsored by Mackenzie Financial earlier this year indicated that 11% of those without a TFSA cited a lack of information as a primary reason for not setting up an account. Bank of Montreal followed up this poll with their own survey that suggested the largest participation in TFSA's was from older Canadians – those age 65 and older.

What does this mean for financial advisors? A wonderful opportunity exists to tap in to the majority of Canadians without a TFSA with a view towards educating and promoting the benefits of this versatile account.



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Estate planning implications

Much has been written about the TFSA's advantages: the accumulation of tax-free income, the ability to re-contribute withdrawals, and access to funds without impact on federally sponsored benefits such as Old Age Security (OAS). But, not much has been said about the estate planning implications of a TFSA. Given

that the majority of TFSA holders are 65 and older, you might soon have to answer questions regarding implications at death. What happens to a TFSA on death of the TFSA holder?

TFSA legislation allows TFSA holders to name a successor holder. The successor holder must be a spouse or common-law partner (CLP). By virtue of this designation, the successor will acquire all rights of the original TFSA holder on the holder's death. Similar to the successor annuitant on a Registered Retirement Income Fund (RRIF), the successor holder simply replaces the original TFSA holder, and the plan continues with all rights passing to the successor. Successor holders do not require TFSA contribution room to receive this benefit.

The naming of a successor holder is effective in ensuring that income earned after the original holder's death is not taxed. Without a successor holder, TFSA legislation requires taxation of income earned in the TFSA after death. Consider the following example:

Allan, a TFSA holder, died with a TFSA valued at \$35,000 at the time of his death. Allan's spouse, Meg, was not named successor holder, but was entitled to his TFSA by way of his will. Six months after Allan's death his TFSA was closed. Between the time of death and the closing of his plan, the TFSA increased by \$2,000. As beneficiary of his estate, Meg received \$37,000 from Allan's TFSA, \$2,000 of which was fully taxable to her as ordinary income.

Notice that \$35,000 was received by Meg tax-free. This represents income earned in the TFSA prior to Allan's death - income that remains tax free when paid to beneficiaries. However, because a successor holder was not named, the \$2,000 earned after death became taxable. If Meg had been named successor holder of Allan's TFSA, she would have replaced him as holder, and the \$2,000 would have been earned tax-free.

If your client fails to name a successor holder for their TFSA, would their heirs require TFSA contribution room to continue to earn tax-free income after your client's death? It depends. If your client's spouse or CLP inherits the TFSA (e.g., by way of will), the spouse or CLP would be known as survivor, and the value of the plan on the date of your client's death can be contributed to the survivor's TFSA without requiring contribution room. This is called an exempt contribution and must occur on or before December 31st of the year following your client's death. The survivor



must also designate the contribution as an exempt contribution on CRA form RC240, *Designating an Exempt Contribution to a Survivor Tax-Free Savings Account (TFSA)*, and file the form with the CRA within 30 days of the contribution. Amounts earned in your client's TFSA after death, but before distribution to a survivor, would require TFSA contribution room for future tax sheltering.

Of the \$37,000 Meg received, \$35,000 was contributed to her TFSA without impact to her contribution room: the contribution occurred before December 31 of the year following death and she designated the contribution on CRA form RC240 within 30 days of the contribution. Also, although she was taxed on the \$2,000 earned in Allan's TFSA after death, her available TFSA contribution room allowed her to contribute this amount to her TFSA, providing for future tax sheltering for the entire amount (\$37,000).

When someone other than a spouse or CLP inherits a TFSA, the tax-free amount earned before death is still passed to beneficiaries tax free. Amounts earned after death but before distribution are taxable, and TFSA contribution room is required to shelter all amounts from future tax. Only a spouse or CLP is entitled to an exempt contribution.

Beneficiary designations

When the TFSA was launched in January 2008, questions came up about beneficiary designations.

Are beneficiary designations permitted on TFSA applications? Similar to RRSPs and RRIFs, would beneficiary designations on TFSA applications allow the asset to bypass the estate of the deceased and transfer directly to named beneficiaries? This would normally simplify the distribution of TFSA assets and reduce administrative costs such as probate fees. Has provision for such a designation been made for the TFSA? Or, as illustrated by Allan and Meg above, must the asset be transferred by way of a will?

Other than the right to name a successor holder, no mention of beneficiary designations is made in federal TFSA legislation. This is not unusual, as the transfer of assets at death is governed by provincial and territorial legislation. In order to transfer TFSAs to beneficiaries by way of a plan designation, provincial or territorial legislation must allow for it.

Since January, all provinces (other than Quebec) have updated their respective legislations to allow for beneficiary designations on TFSA applications. For the province of Quebec, TFSA transfers at death will continue to pass through the deceased's estate and will be governed by the deceased's will.

As you prepare for client meetings during RRSP season, don't forget to discuss TFSAs. Seventy-five percent of Canadians have yet to discover this great opportunity – an opportunity you can be the first to share with them. A review of beneficiary or successor holder designations for your clients will ensure they have the designations they need.