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Naming Your Estate as a Beneficiary

It often makes good financial sense for spouses to name each other as the beneficiaries of their Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Tax Free Savings Account (TFSA), life insurance proceeds or similar assets. However, there may be situations to name your estate as the beneficiary of these kinds of assets:

1. To ensure that there are funds available in your estate to pay for your funeral, burial and other debts and liabilities such as taxes;
2. To make sure your estate is distributed fairly among your beneficiaries (often your children and grandchildren); and,
3. To ensure there is enough money to carry out your wishes, for example, having enough money to fund a trust.

A Typical Scenario

In this hypothetical scenario, names and facts are fictitious. Janet is a widow with two grown children, John and Sarah. Janet has four grandchildren – two by John and two by Sarah. Janet's assets include:

- RRIF valued at $600,000
- TFSA worth $32,000
- Term life insurance of $100,000
- A home worth $200,000
- Savings account of $50,000

Janet's financial planner said she should name her children as beneficiaries of her RRIF, TFSA, and life insurance. The financial planner wanted her estate to pay as little of the estate administration tax (commonly known as probate fees) as possible. By naming beneficiaries, no estate administration tax (EAT) is payable on these assets which will pass directly to the named beneficiaries rather than becoming part of Janet's estate.

What Janet did not realize is that there are some important reasons why this might not be a good idea and could end up with unfair results that she did not intend.

EAT payable is approximately 1.5% of the value of estate assets. Sometimes paying EAT can be a small price to pay for organizing your affairs in a way that makes sense to you and accomplishes what you want to happen with your assets after your death. Many problems are created when "avoiding EAT at all costs" is the kind of thinking that drives estate planning.

Can the Estate Pay its Bills?

Lots of people don't realize that there are many other things that should be considered first. On death, almost half of all RRSPs, RRIFs and similar assets (we'll refer to them collectively as registered plan proceeds) will be payable to Canada Revenue Agency (CRA) as income tax unless it is possible to roll over the registered plan proceeds on a tax-deferred basis to a surviving spouse's RRSP, RRIF. Tax deferral may also be possible where the beneficiary of registered plan proceeds is a minor or has a disability tax credit (DTC) certificate.

Why is so much income tax payable? In the year of death, an individual's entire registered plan proceeds are considered income. All other income received in the year of death, such as Old Age Security, Canada Pension Plan, earned income, interest and dividends, are combined with the registered plan proceeds often pushing the individual's total income into the highest marginal income tax bracket.

It is important to be aware that on death the financial institution will pay the entire registered plan proceeds to the named beneficiaries. Nothing is held back for income tax liability (as it would be if the individual cashed out the registered plan during his or her lifetime). As a result, the large income tax bill is payable from the individual's estate and beneficiaries named in the Will end up footing the tax bill.

If the registered plan beneficiaries are exactly the same as those named in the Will, there may not be a problem.

However, if all of the funds from a registered plan are paid out directly to named beneficiaries, there may not be enough money left in the estate to pay bills such as funeral and burial costs, or capital gains tax on a cottage or the deemed or actual disposition of shares of a corporation or other capital property. Without proper planning the estate could end up insolvent (without enough money to pay its debts).

Let's look at Janet's case as an example. If her two children are named as her RRIF beneficiaries, on her death the financial institution pays the entire $600,000 RRIF to John and Sarah. That leaves Janet's estate to pay the income tax bill for the RRIF (which could be almost half of the RRIF or $300,000). As you can see, if Janet's TFSA and life insurance are also paid to Janet's two children and flow outside her estate, there will only be $250,000 in her estate (the home and savings account). That isn't enough to pay the income tax owing on the RRIF, not to mention other estate debt or executor's compensation.

In this case, if Janet had named her estate as a beneficiary of the RRIF, it's true that her estate would have paid EAT in the approximate amount of $9,000 (1.5% of the RRIF value) but at least there would have been enough to pay the estate's liabilities.

Ensuring a Fair Distribution

After both parents have died, most people want their children treated equally. If a child dies before a parent, the parent usually wants that child's children (the grandchildren) to receive what the child would have received had he or she been alive.

However, if one spouse dies, and the surviving spouse names the children as the beneficiaries, an unintended inequity can result if one child predeceases the parent. The inequity results if the child who died left children. Only the beneficiaries who are alive will receive the registered plan proceeds, TFSA, or life insurance proceeds. The children of the deceased child do not get a share. The result: is that some grandchildren benefit while others are left out.

Of course updating beneficiary designations could solve this particular problem. However, after the death of a child, what if the parent is not able to change their beneficiary designations because the parent is no longer mentally capable? Or the parent simply doesn't know or remember to make these changes? Or puts it off too long? If the parent dies before updating her designations, the end result is that the beneficiaries (and their families) are not treated fairly.

To illustrate this point, let's return to Janet. Assuming Janet named her two children as the beneficiaries of her RRIF, TFSA, and life insurance, what happens if John dies before his mother, who herself passes away without changing her beneficiary designations?

The answer is that Sarah will receive the bulk of Janet's estate (that is, the RRIF, TFSA and insurance proceeds which total $732,000) and John's children will receive nothing. This unequal result is because the bulk of Janet's estate has passed outside of her Will to her only living child – while the income tax from the RRIF (approximately $276,000) is payable by Janet's estate. Janet's remaining assets - her home and savings account will not cover the income tax (not to mention her funeral and other possible liabilities). Under this scenario, nothing is left for John's children.

Naming the estate as a beneficiary of an RRSP, RRIF, TFSA, or insurance policy avoids these problems. All of the assets would flow into the parent's estate and would be distributed according to the parent's Will. It is true that the approximately 1.5% of the value of the estate would have been paid to cover EAT. However, we think this is a small price to pay for the peace of mind gained in knowing that your beneficiaries and their families will be dealt with fairly and according to your wishes.

Distributing Assets and Funding Trusts

The small space on a beneficiary designation form makes it impossible to provide for the variety of possible scenarios that can be easily covered in a Will. In our view, the comparatively modest amount of EAT payable on the value of RRSPs/RRIFs, TFSAs or insurance policies is usually worth paying to ensure that what you want to happen with your assets will actually happen. This can only be accomplished through a well-drafted Will.

There are other instances where it is important to designate the estate as beneficiary. This is particularly true where a Will contains one or more trusts for the benefit of certain beneficiaries. Naming the estate as beneficiary can ensure that there are funds for a trust that is included in in the Will. In some cases where the estate is not the beneficiary of the RRSP/RRIF, TFSA or insurance proceeds, there may be nothing to fund a trust in the Will.

Despite recent changes to the taxation of testamentary trusts, we still recommend trusts for clients who would like to:

1. Provide a son or daughter with the opportunity of income-splitting with his or her spouse and children to reduce overall tax within the son's or daughter's family,
2. Prevent the loss of disability income and other government benefits such as drug and dental coverage for a beneficiary who has a disability,
3. Ensure a spouse from a second relationship is taken care of but that when the surviving spouse dies, the client's own children from a previous relationship receive remaining funds, not the new spouse's family or new partner,
4. Provide a trust for a beneficiary who is known to be a spendthrift and who could benefit from controlled access to his or her inheritance,
5. Set aside funds for a nuimon beneficiary in a trust that continues beyond the age of 18 rather than having the child receive the entire inheritance at 18 regardless of the child's ability to handle large sums of money.

In general, keep in mind that there may be other scenarios that would warrant a client creating a trust in a separate document outside of one's Will, such as an insurance trust declaration, a joint partner trust or an alter ego trust. If you have questions about your Will or other estate planning documents, make an appointment with us to discuss them.

Estate planning is complex. There are many factors to take into consideration. Probate fees are just one of these considerations. Your lawyer should work closely with your FP and the other pop with whom you work to ensure your assets include any ben designs are structured so as to achieve your estate planning goals.

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