Choose your RRSP beneficiaries carefully to take advantage of tax deferral

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Some laws can be tough to understand. Consider the city of Brighton, Mich., which passed an ordinance that became effective this year, making it illegal for anyone to be annoying in public.

Tax and estate laws can also be tough to comprehend. Since it's the season for registered retirement savings plans, let's talk about who you should name as the beneficiary of your RRSP. The discussion here also applies to registered retirement income funds - that is, RRIFs.

Your Spouse

It just makes sense to name your spouse as the beneficiary of your plan in most cases, because the plan assets can transfer to your spouse on a tax-deferred basis.

At the time of your death, you'll face tax on the full value of your plan assets. The result could be that almost half of your registered plan could end up in the Canada Revenue Agency's pockets. If you name your spouse as the beneficiary of your plan, you'll side-step that tax bill, but your spouse will become taxable on that same value.

Your spouse, however, can then defer the tax on the plan assets by transferring the registered plan assets to an RRSP or RRIF. Presto, tax has been deferred, and your spouse will pay tax only when he or she makes withdrawals from the plan.

Your dependent children

It's also possible to defer tax by naming a child or grandchild as the beneficiary of your plan. If the child is a minor, or has a mental or physical infirmity, and is financially dependent on you at the time of your death, you can leave your plan assets to that child and defer tax.

In the case of a minor child, the only option is to buy an annuity with the plan assets that will make payments each year until the child reaches age 18. The child will face tax on each payment made under the annuity.

For adult children or grandchildren who are infirm, the plan assets can be transferred to his or her own RRSP, and tax will be paid by him or her when withdrawals are made. Sorry, but you won't be able to achieve a deferral of tax if your children are adults and are not mentally or physically infirm (even if they're financially dependent on you - which I fully expect will be the case with my kids until they're about 40 years old - I'm guessing).

Your Estate

You can also name your estate as the beneficiary of your registered plan. In this case, you can count on tax being owed on your final tax return on the value of the plan assets. You should know that it's possible for your executor to make a joint election with your spouse (or a qualifying dependent child) to make a tax-deferred transfer of the plan assets to your spouse's (or child's) plan. If your province levies probate fees, the value of the plan assets will be subject to those fees if you name your estate as beneficiary.

Your Favourite Charity

You can also name a registered charity as the beneficiary of your registered plan. Once upon a time this would not have given rise to a donation tax credit, but thankfully the government used common sense and changed this a few years ago. Today, you can name a charity as beneficiary, and you'll be entitled to a donation credit on your final tax return for the value donated to charity. This should offset the tax owing on the plan at the time of your death.

Others

If you name someone other than those I've listed above as the beneficiary of your RRSP or RRIF, you'll face tax on the value of the plan in your year of death.

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