

TFSAs and Estate Planning

Much has been written about the new tax-free savings accounts: the accumulation of tax-free income, the ability to re-contribute withdrawals and the capacity to access funds without impact to federally sponsored benefits. But what happens to the TFSA on death of the TFSA holder?

Generally, clients who have a TFSA can name a "successor holder" or a "beneficiary." Only a spouse or common-law partner (CLP) can be a successor holder. By virtue of this designation, the successor will acquire all rights of the original TFSA holder on death. Similar to the successor annuitant on an RRIF, the successor holder simply replaces the original TFSA holder, and the plan continues with all rights passing to the successor. The successor holder will not require TFSA contribution room to receive this benefit.

From a tax perspective, having a successor holder is effective in ensuring that income earned after the client's death is not taxed. Consider the following example:

Allan, a TFSA holder, passed away 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 Allan's 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 recipient of his TFSA proceeds, Meg received \$37,000 from Allan's TFSA, \$2,000 of which was fully taxable to her as 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 was taxable. If Meg were named successor holder of Allan's TFSA, she would have replaced him as holder on his death, the TFSA would have continued, and the \$2,000 would have been earned tax-free.

If your client fails to name a successor holder for his or her TFSA, does this mean TFSA contribution room is required for heirs to continue to earn tax-free income after the client's death? It depends. If your client's spouse or CLP will inherit the TFSA, the value of the plan on your client's date of death can be contributed to the spouse's TFSA without impact to his or her contribution room. This is called an "exempt contribution" and, under proposed legislation, must occur on or before December 31 of the year following the client's death. The spouse or CLP must also designate the contribution as an exempt contribution on CRA form RC240 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 would require contribution room for future tax sheltering. Let's look at the Meg and Allan example again:

Of the \$37,000 received by Meg, \$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 after the contribution. Although she was taxed on the \$2,000 earned in Allan's TFSA after his death, her available TFSA contribution room allowed her to contribute this amount to her TFSA, providing for future tax sheltering of the entire amount (\$37,000).

If someone other than a spouse or CLP inherits the 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

In preparing for the new TFSA environment, questions have come up about beneficiary designations. Are beneficiary designations permitted on TFSA applications? Would a beneficiary designation on a TFSA application allow the asset to bypass the estate of the deceased and transfer directly to named beneficiaries, as is the case with many RRSPs and RRIFs? Naming beneficiaries on an application can simplify asset distribution and reduce administrative costs such as probate fees.

Interestingly, 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 RRSPs, RRIFs or TFSAs to beneficiaries by way of a plan designation, provincial or territorial legislation must allow for it. While this legislation is in place for RRSPs and RRIFs, at the time of writing, only British Columbia, Alberta, Nova Scotia and Prince Edward Island have introduced legislation to allow for such a designation for TFSAs. Similar provisions in the remaining provinces and territories have not yet been made.

Until such provisions are introduced, TFSA assets in the remaining provinces and territories will pass to beneficiaries by way of a deceased's will and, in the case of provinces that levy estate administration fees, may be subject to probate fees.

Several groups, including the Investment Funds Institute of Canada, have written the provinces and territories recommending updates to legislation to allow for the transfer of TFSAs by means other than a will. In anticipation of this, some financial institutions are accepting TFSA applications that allow for a successor holder or beneficiary designation.

Until provincial and territorial updates are made, clients who hold TFSAs should indicate intentions in their wills to ensure their wishes are carried out at death, even when a successor holder or beneficiary designation is made directly on a TFSA application. (In Quebec, it is expected that TFSA transfers at death will not be permitted by means other than a will.)

As you approach your clients to discuss the TFSA, don't forget to address estate planning details. Not only will it help ensure TFSAs are addressed appropriately in the case of death, but it might also lead to larger estate planning discussions — something every client should consider.