O'SULLIVAN
ESTATE LAWYERS

March 2023

Advisory

Succession planning with life insurance and registered savings

Life insurance and registered savings, such as registered retirement savings plans ("RRSPs"), registered retirement income funds ("RRIFs"), private pensions and tax-free savings accounts ("TFSAs") can form an income tax efficient part of an estate plan and can be structured to allow for estate administration tax and probate fee savings and creditor protection. These types of assets are governed by specific legislation, which impact how they may be given to beneficiaries and death. This Advisory provides a high level overview of these assets in the context of succession planning.

Life Insurance

Life insurance involves an agreement with an insurance company under which premiums are paid for a specified period of time in exchange for an eventual payment of a death benefit to a beneficiary upon an insured individual's death. Life insurance can be used to build wealth, replace income, add liquidity to a deceased's estate, fund taxes, provide financial security for beneficiaries or help with the equalization of an estate where there are multiple beneficiaries.

Types of Life Insurance

Different types of life insurance products are available. Two of the most common types of life insurance are term life insurance and whole life insurance. Term life insurance can cover a specified period of time, such as 10 years and whole life insurance can cover an unspecified period until death. Insurance can cover the life of one person or of two persons and pay a death benefit on the death of the first or last to die of the insured persons, or provide coverage for a group of insured persons, such as under a group policy purchased by an employer.

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Advantages and Disadvantages of Life Insurance

In Canada, the receipt of a life insurance death benefit on a policy owned by an individual owner is not subject to income tax as it is considered a receipt of capital, which is one of the key benefits of life insurance. Further, provided life insurance benefits are designated as payable to a beneficiary other than the insured's estate, they generally pass outside of the insured's estate and do not form a part of the value of the estate for the purpose of calculating Ontario Estate Administration Tax ("EAT"), which is payable at the rate of approximately 1.5% of the value of an estate. For example, if $1 million dollars is designated to a named beneficiary in the form of a life insurance benefit, approximately $15,000 of EAT would be saved, in contrast to $1 million dollars payable to the estate of the deceased, which would increase the EAT by $15,000.

Life insurance proceeds may also be structured to protect them from the insured person's creditors. Under the Ontario *Insurance Act*, where life insurance proceeds are designated as payable to any beneficiary irrevocably or to the insured person's spouse, child, grandchild or parent, all amounts payable under an insurance contract remain out of the insured person's creditors' reach during the lifetime of the insured person. Following the death of the insured person, where a beneficiary other than the insured person's estate is designated as beneficiary of a death benefit, the death benefit remains out of reach of the insured person's creditors.

Corporately Owned Life Insurance

Life insurance may be purchased and owned by the insured person or by a third party, such as a spouse or a private corporation. It may be efficient for certain small business corporations which pay a reduced income tax rate to own life insurance. Where a corporation is the recipient of the death benefit, on the death of the insured, the benefit would generally be received by the corporation free of income tax and be added to the capital dividend account of the corporation, which could then be paid out to the corporation's Canadian-resident shareholders as a capital dividend free of income tax. However, life insurance proceeds payable to the corporation as a beneficiary would generally be exposed to the corporation's shareholders' creditor claims before the funds could be paid out to the shareholders. If an individual is named as a beneficiary of a corporately-owned life insurance policy, the death benefit may be subject to a taxable benefit tax treatment in the hands of the individual recipient, which would be a tax-inefficient outcome.

Designating Beneficiaries of Life Insurance

In Ontario, the *Insurance Act* governs the designation of beneficiaries of a life insurance policy. It provides that an insured may make or change a revocable designation in the insurance contract or by a declaration. A declaration may be contained in a will or another document. Generally, the last designation or declaration prevails against earlier ones. A designation only governs a contract in existence at the date of the declaration and should refer to it specifically, naming the contract and its identifying details.

Insurance declarations are frequently completed in conjunction with estate planning documents. Generally, such declarations will be included in the introductory provisions of the insured's will which deal with matters other than the insured's estate assets. In the case of a jointly owned joint and last to die life insurance policy, a declaration is generally completed jointly by the insured owners in a separate, jointly executed insurance declaration.

Although a designation made inside the insurance contract in the form provided by the insurance company ensures that the intended beneficiary will receive the payment of the death benefit, a declaration provided for in a will provides for more flexibility. A declaration in a will allows for the ability to include flexible trust provisions, including the appointment of trustees to hold the insurance proceeds, and can provide a series of contingent beneficiaries as well as other terms and conditions which can parallel the provisions of the will plan for the estate. The designation provision in an insurance contract offers very limited options and can create problems, particularly if there are minor beneficiaries. Many have no provisions for the appointment of a trustee to receive insurance proceeds on behalf of a minor, and those that do are very limited in their terms often requiring payment of the proceeds to the beneficiary at the age of majority, as opposed to a more financially mature age. If minors are named as beneficiaries, the proceeds are required to be paid into court for their benefit or to a court appointed legal guardian in the absence of specific trust provisions.

As noted above, it is possible to make irrevocable beneficiary designations under the *Insurance Act*, which provides certain benefits to the insured, such as creditor protection. The Act requires such a designation to be made either in the insurance contract or in a declaration that is a separate document from the insured's will and such a designation document must be filed with the insurer at its head or principal office in Canada. Where an irrevocable designation is made, it cannot be altered or revoked without the consent of the beneficiary while the beneficiary is living. Where the irrevocable beneficiary is a minor, the consent would only be valid if the beneficiary was at least 18 years old.

Annuities

An annuity is a financial product provided by a life insurance company, that pays a guaranteed or a variable income for a specific period of time (a "term-certain annuity") or until the death (a "life annuity") of the beneficiary (called the "annuitant"). Annuities are frequently used to provide for retirement or disability funding.

Funding of Annuities

Annuities may be purchased with registered funds that may have been previously exempted from income tax, such as funds inside a RRSP, a Locked-In Retirement Account ("LIRA"), Individual Pension Plan ("IPP") or Registered Disability Savings Plan ("RDSP"), with registered pension plan funds, or with ordinary after-tax savings. The source of funding generally determines the annual income tax treatment of the annuity benefits during the lifetime of the annuitant.

Types of Annuities

There are many different types of annuity products available, which may allow single or joint annuitant options and which may or may not permit the designation of successor beneficiaries upon the death of the annuitant(s). Beneficiaries may in some cases step into the shoes of a deceased annuitant and receive annuity income or alternatively receive a single lump-sum payment upon the death of the annuitant. The income tax treatment of the death benefit also varies. For instance, if the annuity death benefit is in the form of continued income received by a successor, it would generally be taxed in the hands of the successor; if received as a lump sum, it may be taxed in the hands of the deceased annuitant's estate. Both the lifetime and death benefit taxation of annuities should be confirmed with the assistance of tax advisors.

Designating Beneficiaries of Annuities

In addition to the federal *Income Tax Act* mandating the taxation of annuities, annuities are also subject to provincial legislation for succession law purposes. In Ontario, annuities are included in the definition of life insurance under the *Insurance Act*. Similarly to life insurance death benefits, annuity death benefits generally pass outside of the estate, bypassing EAT and the creditors of the deceased. Where an annuity permits a designation of beneficiaries, such a designation should be completed either in the annuity contract or by way of a declaration as discussed above with respect to life insurance.

RRSPs and RRIFs

RRSPs were first introduced in 1957 and the rules governing them since then have evolved significantly. RRSPs are a federal Canadian income tax program designed to encourage individuals to save for retirement by allowing a deferral of annual income tax on permitted contributed earnings at a time taxpayers are expected to be in higher marginal income tax brackets to a time they are expected to be in lower marginal income tax brackets.

Lifetime Taxation of RRSPs and RRIFs

Generally, contributions to RRSPs are deductible from the contributor's (generally called the "annuitant") taxable income. The contributions are dependent on contribution room which is determined in relation to the annuitant's annual earnings. Unused contribution room is carried forward indefinitely.

Another attractive feature of RRSPs is that contributions to spousal RRSPs are permitted without the application of tax attribution rules, which generally apply in Canada on financial transfers between spouses that lead to taxable income in the hands of the recipient spouse. Spousal RRSP contributions must be within the contributing spouse's annual contribution limit in order for the attribution rules not to apply.

Contributed funds grow and compound inside the RRSP on a tax-deferred basis. RRSP proceeds are included in the annuitant's income on their withdrawal. Generally, an RRSP must be converted to a RRIF, an annuity, or be withdrawn as a taxable lump sum payment by the end of the calendar year the annuitant turns 71. RRSP and RRIF funds are generally permitted to be invested in investments such as public equities, mutual funds, investment funds and guaranteed income certificates. Under the *Income Tax Act*, a RRIF is subject to mandatory minimum graduated annual withdrawals that are calculated in reference to the annuitant's age. The *Income Tax Act* permits the splitting of RRSP/RRIF income between spouses, which is consistent with the rule that permits spousal contributions.

Designating Survivor Beneficiaries of RRSPs and RRIFs

By default, if no beneficiary of an RRSP or a RRIF is named, on the death of the annuitant, the full balance in the RRSP or RRIF is paid to the annuitant's estate and the full amount is included as ordinary income in the terminal year income tax return of the deceased. The terminal year will generally have many actual and deemed income inclusions and it may be likely that the top marginal income tax rate will apply such that more than half of RRSP or RRIF funds, as applicable, could be lost to income tax. Such a payment to the estate also means that the RRSP/RRIF funds will form part of the value of the estate at the date of death and their entire pre-tax amount will be subject to EAT of 1.5% and also be exposed to the deceased's creditors.

It is possible to designate a married or common-law spouse or a financially dependent minor child or grandchild or a financially-dependent infirm adult child or grandchild as an eligible beneficiary to receive the deceased annuitant's RRSP or RRIF funds on a rollover basis and without an income tax cost to the annuitant's estate.

In the case of a spouse, the designation may be either as a designated beneficiary or as a successor annuitant, both of which options permit a tax-deferred rollover of the funds to the survivor. A successor annuitant designation permits the surviving spouse to step into the shoes of the deceased annuitant without having to liquidate the RRSP or RRIF, as applicable. Where the annuitant designates the surviving spouse as a designated beneficiary and not a successor annuitant, the surviving spouse is able to elect the designation to be that of a successor annuitant.

Income earned inside the RRSP/RRIF following the death of the original annuitant, where an eligible beneficiary is designated, will be taxed in the hands of the beneficiary. Otherwise, it will form income of the estate and will be taxed as part of the estate. Unless the estate qualifies as a graduated rate estate, a special tax status under income tax legislation, which status is available only during the first 36 months after the death of the deceased, the estate will not benefit from graduated rate taxes and will be taxed at the highest marginal tax rate.

It is important to appreciate who bears the income tax burden on RRSP/RRIF proceeds and income, particularly in estate plans that name different persons as beneficiaries of the RRSP than of the residue of the estate. Generally, where no rollover to an eligible beneficiary is available, the RRSP/RRIF will be included in the income of the original (deceased) annuitant and the income tax resulting thereon will generally be payable by the estate and not by the beneficiaries of the RRSP. This tax burden may significantly reduce the value of the residue of the estate at the cost of the beneficiaries of the residue of the estate although the intention may have been to treat each group of beneficiaries equally. It is therefore important to ensure that such tax implications are carefully evaluated with proper professional advice.

For U.S. persons living in Canada, RRSPs and RRIFs may be exempt from passive foreign investment corporation ("PFIC") reporting. They are further exempt from Form 3520-A reporting (annual information return of foreign trust with a U.S. owner). Finally, under the Canada-U.S. Tax Treaty, they are recognized as tax-deferred accounts for U.S. tax purposes.

Creditor Protection on Death for RRSPs and RRIFs

In Ontario where RRSPs and RRIFs are designated in favour of an individual and not in favour of the annuitant's estate, on death the proceeds pass outside of the estate of the original (deceased) annuitant and are protected against the deceased annuitant's creditors based on Ontario case law.

Individual Pension Plans

Individual Pension Plans ("IPPs") are defined-benefit pension plans governed by the *Income Tax Act* and by provincial pension legislation. IPPs are generally provided for shareholders-employees of private Canadian companies as a means to fund their retirement. IPPs are generally provided for less than four beneficiaries, at least one of whom is related to the provider company.

IPPs are subject to complex employee-employer funding and taxation rules that are tied to the beneficiary's employment earnings. IPP funding and mandatory withdrawal rules were changed in the recent past, eliminating some of the advantages IPPs have historically had over other retirement funding products. Nevertheless, IPPs may remain an attractive option for some private companies, such as those at risk of the passive investment income tax that applies to annual investment income in excess of $50,000. By eligibly transferring their passive funds to an IPP such companies may minimize their corporate income taxes.

In Ontario, the *Pension Benefits Act* requires that the beneficiary's spouse be named as the primary death beneficiary for pre- and post-retirement death benefit purposes. The IPP beneficiary can designate another death beneficiary or death beneficiaries to receive death benefits only if the spouse signs a waiver to that effect.

The IPP beneficiary may designate a contingent beneficiary to receive pre-retirement death benefits in the event that the spouse predeceases the beneficiary. Post-retirement death benefits are governed by the terms of the agreement as selected by the member.

TFSAs

The TFSA program has been described as the single most important personal savings vehicle since the introduction of RRSPs. It has been in place since January 1, 2009 for Canadian-resident individuals who are at least 18 years old. The TFSA program provides a means to save investment-type income on a completely tax-free basis.

The TFSA Model

Since its introduction in 2009, the TFSA program permitted individuals to contribute between $5,000 and $10,000 on an annual basis to a TFSA which is generally held with a Canadian financial institution. Unused contribution room can be carried forward indefinitely. On a cumulative basis, by 2023 an individual could have contributed $88,000 to his or her TFSA, as explained in the table below.

Years	TFSA Annual Limit	Cumulative Total
2009–2012	$5,000	$20,000
2013–2014	$5,500	$31,000
2015	$10,000	$41,000
2016–2018	$5,500	$57,500
2019-2022	$6,000	$81,500
2023	$6,500	$88,000

TFSA funds are generally permitted to be invested in investments that are RRSP-eligible, such as public equities, mutual funds, investment funds and guaranteed income certificates.

While contributions to a TFSA are not deductible from the contributor's taxable income, all earnings inside the TFSA and subsequent withdrawals are generally exempt from income taxation in Canada.

Unlike an RRSP, a TFSA is not considered under U.S. tax rules to be a pension plan. TFSAs held by U.S. persons may therefore be at risk of PFIC and grantor foreign trust tax treatment in the U.S. Further, like other non-U.S. accounts, a TFSA may also need to be included on a U.S. citizen's Foreign Bank Account Report ("FBAR"). Earnings inside the TFSA are generally taxed by the U.S. As such, TFSAs are often not recommended as a worthwhile savings vehicle for Canadian residents who are U.S. persons.

Beneficiaries of TFSAs on Death

Since TFSAs are not taxable, on death the proceeds of a TSFA are also not subject to income tax in Canada, whether they are received by the estate or paid to another recipient. In the case of a married or common-law spouse, the *Income Tax Act* allows for a spouse to be named as a successor holder of a deceased's TFSA. A spouse takes over a deceased spouse's TFSA regardless of whether or not the surviving spouse has any remaining individual contribution room.

Under the *Income Tax Act,* a beneficiary who is not a spouse is only permitted to transfer a deceased's TFSA into their own TFSA to the extent the beneficiary has unused contribution room. Otherwise the deceased's TFSA is collapsed and cash is paid to the beneficiary.

Beneficiary Designations and Marital Breakdown

It is important that all beneficiary designations be reviewed upon a marriage breakdown in order to ensure that the desired beneficiaries are named as beneficiaries and appropriate changes made. Under Ontario law, marriage breakdown and divorce do not revoke these designations, and a former spouse may remain as the named beneficiary when the policy owner in fact wished to benefit a current spouse or his or her children or other persons, sometimes resulting in a dispute and litigation.

CONCLUSION

Life insurance, RRSPs, RRIFs, private pensions and TFSAs offer income tax and estate administration tax savings, as well in certain cases creditor protection. As outlined in this Advisory, these financial assets are primarily governed by specific legislation which is often complex. In planning for how these assets should be given on death to beneficiaries, it is important to seek professional advice in order to ensure optimal results in succession planning.