

Tax-free savings accounts have key estate-planning role

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Special to The Globe and Mail

Published Thursday, Jul. 30, 2015 4:39PM EDT

Last updated Tuesday, Sep. 01, 2015 11:51AM EDT

It always amazes me how people scramble to get their estate planning in order a week before they will be hopping on a plane to fly somewhere. In actual fact, you're far more likely to be fatally injured in a car accident than a plane crash.

All of this leads me to conclude that estate planning should be looked after as soon as you can.

Last summer, I wrote a four-part series on the five Ds of estate planning: Define, design, document, discuss and distribute. The summer is a great time to sit back and contemplate that day when you won't be here any more – hey, you've got to do it some time.

Today, I want to focus on a specific matter that should be dealt with as part of your estate planning: tax-free savings accounts.

The issues

TFSA's are unique in that assets can grow and be withdrawn tax-free from the plan. A couple of thoughts come to mind here. First, the fact that money comes out of your TFSA free of tax is important. When you die, you'll be deemed to have sold all of your capital property, which generally gives rise to a tax bill on capital gains when you pass away (with some exceptions). Not so with your TFSA. Assets inside your TFSA can come out of that plan free of tax at the time of your death.

So, if you're going to leave assets to heirs at the time of your death, wouldn't it make sense to put as much of those assets in your TFSA as possible so that they pass tax-free to your heirs? Obviously, maximizing your contributions to your TFSA annually is a start. Another idea is to use assets from your registered retirement income fund (RRIF) to make contributions to your TFSA in some cases (see my earlier article at tgam.ca/cestnick-RRIF).

Going against conventional wisdom, you might even choose to put growth assets in your TFSA to the extent those assets will not be spent in your lifetime and will eventually pass to your heirs.

Conventional wisdom suggests that you hold interest-bearing investments inside your TFSA to shelter the highly taxed interest income. This makes logical sense too, but if your primary objective is to minimize tax at the time of death, holding your growth assets in your TFSA may be a better idea.

Now, let's talk about transferring your plan.

The transfer

When you pass away, there are two common ways to leave your TFSA assets to your heirs. First, you could name your spouse or common-law partner (but no one else) as a successor holder. In this case, he or she will step into your shoes and the plan simply continues.

You can designate a successor holder in the TFSA plan documentation, or in your will (provided the will states the successor holder unconditionally acquires all of your rights under the plan including the right to change beneficiaries). The successor holder can continue to contribute to a TFSA based on his or her own contribution room, and can combine your TFSA with his or hers without an issue.

Alternatively, you can name someone as a beneficiary. In this case, the TFSA is de-registered and the assets transfer to the beneficiary (or more than one) free of tax. The beneficiary is deemed to have acquired the assets at fair market value at the time of your death. The beneficiary can contribute the assets to his own TFSA if he has sufficient contribution room. There are no special rules allowing a direct transfer from your TFSA to your beneficiary's plan except in the case of a spouse or partner.

If you name your spouse or partner as beneficiary (as opposed to a successor holder), the transfer to his or her TFSA must be made before the end of the calendar year following the year of your death, the transfer cannot exceed the fair market value of the TFSA at the date of your death (the excess will be taxable), and a prescribed designation election form (Form RC240) must be filed within 30 days after the contribution is made.

It's typically best to name your spouse as successor holder rather than beneficiary; it involves much less paperwork. Even if you name a successor holder, you should still name a beneficiary in case the successor holder dies before you.

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