IG PRIVATE WEALTH MANAGEMENT

Beneficiary designations — The do's and don'ts

Many people designate a beneficiary of their RRSP, RRIF, TFSA or insurance policies without giving it a second thought. However, there are many cases* where designating a direct beneficiary is not recommended. This is a "cheat sheet" as to when direct beneficiary designations should and should not be used. Beneficiary designations are most appropriate in the following circumstances:

Christine Van Cauwenberghe,
B. Comm (Hons),
LL.B., TEP, CFP, RRC
Head of Financial Planning

01 If an individual is in a **first marriage or relationship**, and wants to leave his or her entire estate, including the account/policy in question, to the surviving spouse or partner without concern for children from a previous relationship or other third parties (e.g. charities named in a will). However, if the spouse has a disability or creditor exposure (e.g. is a business owner), then a direct beneficiary designation may not be recommended.

02 Where an individual will not be survived by a spouse or partner, and wants to leave his or her entire estate, including the account/policy in question, to **only one beneficiary** (**e.g. an only child or just one charity**). If he or she is leaving his or her estate to one beneficiary, then the beneficiary should:

- Be of sufficient maturity to manage the funds wisely. When it comes to managing a large sum of money, the definition of "maturity" can vary considerably by individual, but is usually present closer to age 30;
- Not have creditor exposure (e.g. not be a business owner);
- Have reasonable financial management skills; and
- Not have a disability (see below for details as to why this is the case).

03 When there is a concern that **the estate may be bankrupt or insolvent**. If there is a desire to have assets pass outside of your estate in order to avoid future estate creditors, then you should speak to your estates lawyer or notary about how to structure your assets such that you are able to accomplish your estate planning objectives in the most effective manner.

*In Quebec, direct beneficiary designations are only effective on insurance policies and certain types of annuities.

> *If your spouse or partner is not the natural or adoptive parent of all of your children, then you must structure your estate very carefully.*

Direct beneficiary designations are strongly discouraged in other situations, including the following:

1. WHERE ANY BENEFICIARY IS A MINOR (OR A YOUNG ADULT)

In most provinces, surviving parents do not have the authority to manage a minor child's assets, so unless the parents obtain a court order of financial guardianship over the child, the funds may have to be paid to provincial authorities for them to manage. If the beneficiary is technically an adult but still quite young, then the financial institution can take instructions from him or her, but it may not be suitable for a young adult to control a significant inheritance. Where possible, it is usually best to avoid designating minors and young adults as direct beneficiaries. Instead, it is usually preferable to have the funds payable to the estate of the owner of the account or policy, and then for the owner to update his or her will to direct that the funds be held in trust for the minor or young adult until he or she is more mature.

2. WHERE THE BENEFICIARY IS DISABLED

If a person with a disability inherits property directly, he or she may be subject to a clawback of provincial or territorial social assistance. If the person with a disability also happens to be mentally impaired or incapable, then there will be issues with respect to who is entitled to manage the funds; the funds may eventually become payable to the Public Trustee or an equivalent government agency to manage on the beneficiary's behalf. If the person with a disability is only slightly mentally impaired, but vulnerable to financial predators, then having direct control of the inheritance may not be in the person's best interests. To avoid this, it is usually preferable to have the funds payable to the estate of the owner of the account or policy, and then for the owner to update his or her will to direct that the funds be held in a discretionary trust (sometimes referred to as a Henson trust) for the benefit of the individual with a disability. Another advantage of creating a trust is the ability to pay tax at the graduated rates of tax if the trust qualifies as a "qualified disability trust" under the Income Tax Act. If one of your beneficiaries has special needs, ask your IG Consultant for a copy of our article entitled "Leaving an inheritance to a person with disabilities - Henson trusts and other considerations."

3. BLENDED FAMILIES

If you are in a relationship where your spouse or partner is not the natural or adoptive parent of all of your children, then you must structure your estate very carefully. For example, if you leave all of your assets to your spouse, there will be no guarantee that any of your children from a prior relationship will receive anything after your spouse passes away. In some blended families, each spouse will write his or her will such that he or she will leave certain assets directly to the new spouse (or a trust in his or her favor), with other assets being left to the children from a previous relationship, which may be workable. However, in order for this strategy to be effective, you should not make your new spouse the direct beneficiary (or joint owner) of all of your assets, since this may result in no assets being subject to the

terms of your will, and effectively nothing going to your children. If you are a member of a blended family, ask your IG Consultant for a copy of our article, “Estate Planning for Blended Families”.

4. MULTIPLE BENEFICIARIES

Designating multiple beneficiaries is not typically recommended, because if a beneficiary dies before the account or policy holder, the surviving beneficiaries will receive all of the assets in the account or policy and the family of the deceased beneficiary will receive nothing – a result that most individuals do not want. It is also possible that the tax burden for the plan may not be evenly distributed – for example, if you designate three direct beneficiaries of an RRSP and one of them predeceases you, then in most circumstances the two remaining beneficiaries will receive the gross amount in the plan, but the full value of the plan will be taxable to the estate, leaving the heirs of the deceased beneficiaries with less of the estate as well. If you would like to contemplate future generations in your estate plan, you should designate “estate” as your beneficiary, and have your assets distributed through your will.

5. SECONDARY (ALTERNATE, CONTINGENT) DESIGNATIONS

These types of beneficiary designations are also not typically recommended. Most contracts are usually structured so that no contingent beneficiary will inherit any part of the estate until all of the primary beneficiaries are deceased, and then the division is made on a per capita basis between the contingent beneficiaries, not “by branch”. Let’s look at an example where you designate your two children as the primary beneficiaries on an account, with your five grandchildren as the secondary beneficiaries. If one of your children predeceases you, the surviving child will receive the entire amount in the plan, with the grandchildren from the deceased child receiving no part of the funds. If both of your children predecease you, then the policy will be divided in 5 between all of the grandchildren, not divided in 2 and then further divided between each branch of your family. Also, when involving the next generation, there is a greater chance that some of the “secondary” beneficiaries will be minors and/or disabled persons, in which case direct beneficiary designations are generally not recommended, as discussed above.

6. WHERE A BENEFICIARY HAS CREDITOR EXPOSURE

If a beneficiary is insolvent or bankrupt, or there is a concern that his or her assets could be exposed to creditors in the future (for example, if the beneficiary is a business owner, and he or she is concerned about his or her personal liability as a result of that), then it may not be advisable to name him or her as a direct beneficiary. It may be preferable to have the funds payable to the estate of the owner of the account or policy, and then for the owner to update his or her will to direct that the funds be held in a trust for the benefit of the individual, so that there is an added level of creditor protection.

Avoiding probate taxes does not avoid any potential income tax liability.

One other point in particular with respect to insurance policies (which includes guaranteed investment funds (GIFs), also known as segregated funds). Many people mistakenly believe that checking off the “in trust” box on insurance applications provides some assistance. These types of provisions are of questionable effect in Quebec, and even in the rest of the country, all the “in trust” provision means on most insurance applications is that the designated person may hold the funds until the minor reaches the age of majority, which is still usually too young to manage a large lump sum of money. In addition, the trustee is given very little direction as to their rights and responsibilities in managing the money before the minor beneficiary reaches the age of majority. Having the assets pass through the estate (or an insurance trust, which is a type of trust created by a lawyer, not the “in trust” box indicated on an insurance policy) and then distributed over a longer period of time through a discretionary trust is usually a better approach.

As a general observation, many individuals mistakenly believe that all their assets will be divided according to the terms of their will, even if there is a direct beneficiary. It is important to remember that if you designate a direct beneficiary on a plan or policy that these funds will not be distributed according to the terms of your will. If you have created trusts in your will in order to control the distribution of your estate (e.g. perhaps for a minor or disabled person), then designating a direct beneficiary may undermine those plans.

It is also important to understand the tax ramifications of various products. Some common misunderstandings include the following:

- Many people hear rumours about the “tax” payable at the time of death, and believe that by avoiding probate fees (also known as estate administration taxes in Ontario) they will avoid “tax”[1]. However, avoiding probate taxes does not avoid any potential income tax liability. Individuals need to be aware that when a direct beneficiary is designated on an RRSP or RRIF, for example, unless either the deceased or the beneficiary is a non-resident, there will be no withholding for income tax. As a result, the gross amount in the account or policy is paid to the beneficiary, generally leaving the estate with a larger than anticipated income tax liability, with fewer than anticipated assets.
- Even with “insurance” products, which are generally paid out tax-free, it is possible that there could be a tax liability. For example, if someone purchases a non-registered guaranteed investment funds (which is a type of insurance contract that fluctuates in value and could result in a capital gain), then the direct beneficiary will receive the gross amount in the account or policy, but any capital gain realized upon the death of the last annuitant will be taxable to the estate.
- Although some people may have heard that there may be certain tax benefits to designating a minor on an RRSP or RRIF, the tax deferral strategies for these products are generally not effective because in reality no one is willing to go to court to apply for guardianship in order to have the

[1] Probate fees are not payable in Quebec in the same manner as in the common-law provinces

Every situation is unique — your IG Consultant can help ensure your direct beneficiary designations are consistent with your intentions.

ability to deal with the asset during the child's minority. The same comment can be made for persons with a disability – although there are theoretical ways in which RRSPs and RRIFs can be transferred to beneficiaries who have a disability on a tax deferred basis in some cases, these types of beneficiary designations often result in more problems than they solve. A better course of action is to usually designate the estate as the beneficiary and create a trust in your will for the intended recipient. If the after tax value of the plan will not be sufficient for the beneficiary's purposes, you should consider purchasing additional insurance.

There are many other instances in which care should be taken when making a beneficiary designation.

For example:

- Where there is concern about the state of a child's marriage or relationship, then a direct beneficiary designation in favor of the child may not be recommended (creating a trust for that child in your will may be preferable).
- When dealing with an insurance policy owned by a corporation, normally the beneficiary should be the same corporation and not an individual, to avoid adverse tax implications to the shareholders.
- If the plan in question is a pension plan (or locked-in funds derived from a pension plan), then further restrictions apply. Speak to your advisors about the best approach for these assets, since in many cases a surviving spouse or partner will be entitled to receive these funds, regardless of who may be designated as beneficiary.

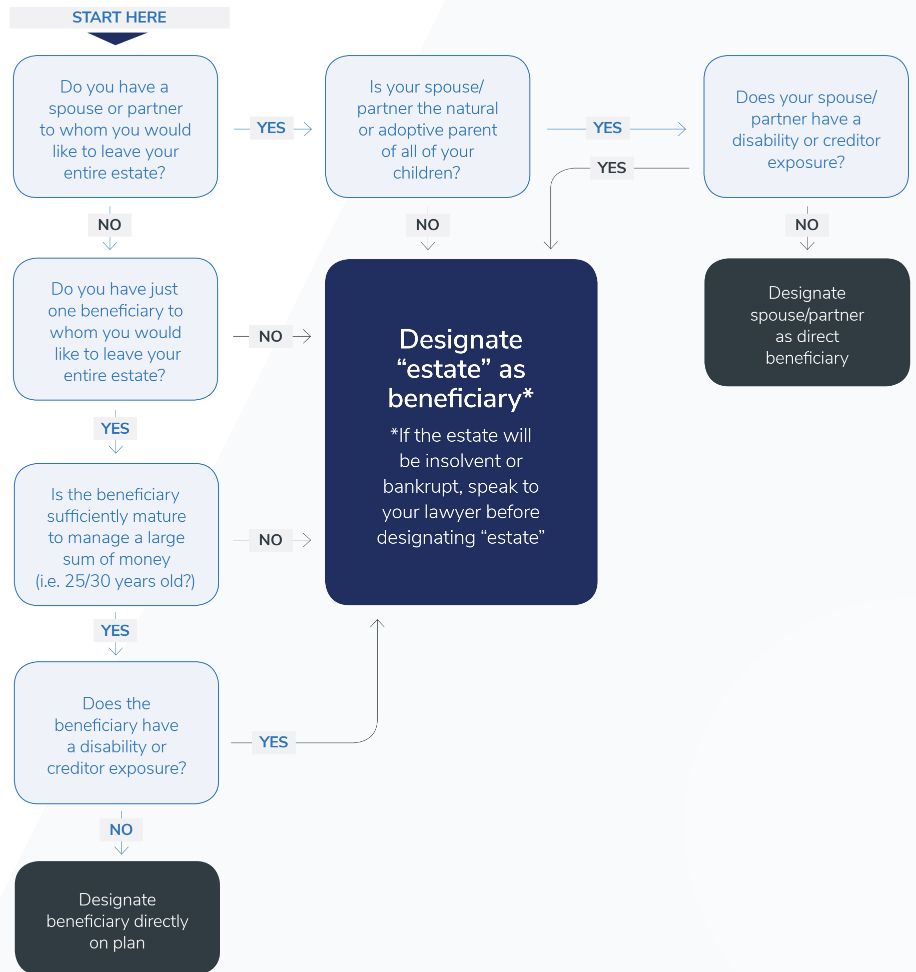
Given all of the above, you should think twice before designating a direct beneficiary to your accounts or policies. We have created a decision tree to help assist you in making this decision. However, since every situation is unique, speak to your IG Consultant and your lawyer (or notary) to ensure that any direct beneficiary designations are consistent with your intentions.

ABOUT THE AUTHOR

Christine Van Cauwenberghe,
B. Comm (Hons),
LL.B., TEP, CFP, RRC
Head of Financial Planning

Christine is Head of Financial Planning at IG Wealth Management, leading our financial planning strategy to ensure that our clients have access to the most advanced expertise. Christine is a member of the Canadian Tax Foundation, has her Certified Financial Planner designation and is a Registered Retirement Consultant and Trust & Estate Practitioner, certified by the Society of Trust & Estate Practitioners (STEP). She is also the recipient of the prestigious STEP Founder's Award. Christine is the author of Wealth Planning Strategies for Canadians, which is published annually by Thomson Carswell and is currently in its 17th edition. Christine has given lectures to numerous professional associations and is a regular media spokesperson for IG Private Wealth Management. Christine has been appointed a King's Counsel for the Province of Manitoba, awarded to lawyers in recognition of exceptional merit in their profession.

BENEFICIARY DESIGNATIONS DECISION TREE



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