Your estate can be passed on to beneficiaries with minimum tax liability

By Derek McClary

Let me introduce to you Ben and Sarah, a typical middle-income couple, who are 65 years of age and are now concerned about making sure their estate transfers to their children.

Ben and Sarah have worked hard all their lives and have accumulated significant wealth. Ben has worked for a large manufacturing company and has accumulated approximately $400,000 in his money purchase pension plan. Sarah has worked for a number of years for one of the large oil and gas companies here in Calgary. She took a few years off to raise her four children of whom she is very proud.

Sarah has accumulated approximately $250,000 in her money purchase pension plan. Sarah and Ben also each have $100,000 in RRSPs. They own their own home, which is in both of their names, and the value today is approximately $600,000. Their possessions include the normal household effects and they both have mid-range vehicles worth about $45,000 total. They also have approximately $50,000 in savings or, as Ben likes to call it, "the- just-in-case fund." They enjoy a moderate lifestyle and with their Old Age Security, Canada Pension Plan, and pension income, they earn about $65,000 per year.

They have not needed to transfer their RRSP investments into a Retire-ment Income Fund at this time, since they do not need the additional income and do not wish to pay any more taxes than they have to. At age 71 they can no longer defer the inevitable and must change their RRSP investments into a Retirement Income Fund or an Annuity, which will be additional taxable income.

Ben and Sarah have two major concerns: 1. They both want to make sure that each one remains financially secure should one of them die before the other. 2. They wish to pass on their estate to their children and grandchildren as easily as possible and as inexpensively as possible, especially as it applies to income taxes.

They have total assets of $1,450,000 not including the personal assets. However, $600,000 is in their home, $650,000 is in Life Income Funds (because it is in pension money), and $200,000 is in Retirement Income funds. On the death of Ben or Sarah, the pension funds that are in the Life Income fund will transition from one spouse to the other without any tax consequences.

At age 65 a minimum amount of four per cent must be withdrawn from the Life Income Funds (since they have started to withdraw money already). The maximum that they could take out of Life Income Funds at age 65 is 8.22% or $53,430.

The maximum amount was somewhat of a surprise to them since they thought they could take as much as they wanted out of their Life Income Funds, not realizing that there were minimums and maximums imposed on pension funds that could, and must, be withdrawn before age 71. Here is a breakdown of Ben and Sarah's income in order to take advantage of effective tax planning:

Ben

Life Income Fund (pension monies) 4% x $450,000 = $18,000.00

Canada Pension Plan = $10,614.96

Old Age Security = $6,027.72

Total = $34,641.68

Sarah

Life Income Fund (pension monies) – 7.42% = $18,553.08

Canada Pension Plan (eligible for partial) = $ 5,777.52

Old Age Security = $6,027.72

Total = $30,358.32

Combined Total = $65,000.00

If Ben predeceases Sarah, Sarah will receive none of Ben's Old Age Security and only 60% of his Canada Pension Plan. This would mean that Sarah's income would drop by $10,273.70 per year. Of course, she can increase the withdrawals from the Life Income Funds to offset this loss or start withdrawing income from the Registered Retirement Income Funds.

Should Sarah predecease Ben, Ben would likewise lose Sarah's Old Age Security and receive only 60% of her Canada Pension Plan. Therefore, Ben's income would drop by $9,493.78 per year.

This would mean that either Ben or Sarah would have to increase their withdrawals from the Life Income Funds or Registered Income Funds to offset this loss of income. A life insurance policy would be an inexpensive way to offset any loss of income without dipping into the registered funds.

Now, if we assume that the returns on the investment funds have equaled the withdrawals, what will the children receive from the estate after mom and dad both pass away?

The personal residence can be sold and the proceeds divided amongst the children with no tax liability. The same with the cash, funds from the sale of the household items and the vehicles. However, the same cannot be said concerning the registered funds. (Life Income Funds, Registered Retirement Savings Plans or the Registered Income Funds). Let's assume that the Life Income Funds and the RRSPs have not decreased in value. Ben and Sarah's Life Income Funds total $650,000 and their combined RRSPs total $200,000. These funds can pass from one spouse to the other without causing a tax liability to the surviving spouse.

However, on the death of the last spouse these funds will go into that spouse's income in the year of death resulting in a huge tax liability. Let's assume that Sarah is the last one to die and she has a total of $850,000 in Registered Funds. This would put her in the highest marginal tax rate, therefore having to pay income tax of 39% on these funds. The result would be that the estate would have to pay income taxes of $331,500.00.

If the investments are held with a life insurance company or companies, these funds would bypass probate and go directly to the named beneficiaries, thus also avoiding legal or executor's fees (which can range from three per cent to five per cent of the value of the estate).

The cheapest way to have the estate pay the income taxes is with a joint and last-to-die life insurance policy, where the insurance policy pays out on the last death, which is when the taxes will become due.

Avoiding probate can be a huge benefit to the survivors. Probate is the process of the courts declaring that there are no other wills that supersedes the one registered. Most banks will freeze the deceased spouse's assets until letters of probate have been granted. This can take as long as six months to a year, or even longer if the will is contested. Even though a spouse may be named as the beneficiary on investments, the financial institutions will require letters of probate. With a life insurance company the investment funds and life insurance products are paid directly to the named beneficiary without letters of probate, thus reducing the waiting time for the loved ones to receive the proceeds.

This is what Ben and Sarah decided to do.

First, they contacted their lawyer and drafted a new will, since the last one was way out of date. They decided to name their four children equal beneficiaries of their estate. Secondly, they met with their insurance advisor and moved their investments to an insurance company and named each other the beneficiary. To eliminate the need for probate on their investments should one predecease the other, they also named their children contingent beneficiaries in case they both died at the same time.

Thirdly, they both decided to purchase a $120,000 life insurance to take care of the drop in income upon each other's death by losing the other's Old Age Security and the reduction of the Canada Pension Benefit. Even with premiums costing perhaps a couple of hundred dollars a month, the savings can be significant.

Fourth, they purchased a $350,000 joint and last-to-die life insurance policy to pay the income tax which would be due on the last death, thus saving the estate over $250,000. By moving their funds to an insurance company and naming each as beneficiaries, and the children as contingent beneficiaries, they moved $850,000 of assets that would no longer be subject to legal or executor fees, saving approximately another $25,000.

Thus the estate would pass from one to the other and to the next generation with little difficulty, and relatively inexpensively, when it came to paying taxes.

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