Insurance

RRSP and RRIF Taxes at Death

Most Canadian articles written on the topic of long-term investing would probably recommend that you maximize your RRSP contributions, and quite rightly so. RRSPs and RRIFs offer tax advantages while the contributors are alive: all growth inside the RRSP or RRIF is tax deferred, and contributions made to an RRSP are tax deductible. What most people are unaware of is the large tax bill that is payable upon the death of the RRSP holder, if the disbursements are not properly planned. This is because tax is payable on any RRSP / RRIF withdrawals in the year they are made.

At death, the Canada Customs and Revenue Agency (CCRA) considers you to have cashed in **all** of your RRSPs and RRIFs in that year. The consequence is that you must pay tax on the value of the RRSPs and RRIFs just as you would if you had taken it as income when you were alive. And if that sum of money is large enough, you may have to pay as much as half of it as tax.

There are however a few options one can choose from to defer, or in certain instances, minimize the tax implications. Every individual situation is different and professional advice should be sought before any final decisions are made, but here are some general ideas and techniques that are extremely effective:

Spousal Rollover: The most basic option is the “Spousal Rollover” – naming the spouse as the beneficiary. In the event of the contributor’s death, the RRSP / RRIF is then rolled over to the spouse, without any tax implication to the contributor’s estate.

Charitable Donations: Charitable giving from your estate is an extremely effective way to reduce taxes that are payable in the year of death, if you are committed to a charity. In fact, a 100% of the donation from your estate to any qualified charitable organization qualifies as a tax credit that can be used against your final tax return. Theoretically, this could reduce any taxes payable by your estate to $0, but whether or not this would be a prudent financial decision would depend on your wishes after consultation with your advisors.

Insuring the RRSPs/RRIFs: This is another effective solution to minimizing the tax implications. By insuring your RRSPs and RRIFs, you greatly reduce the amount of tax your estate must pay. This technique effectively redirects any surplus money – money that you do not require for living or lifestyle expenses; to an insurance contract. The insurance then pays your estate taxes, greatly reducing the tax burden on your estate and your heirs. Let's look at an example.

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**Example*

Mr. and Mrs. Brown, both 70 years of age, have RRIFs currently worth $750,000 in total. They will need $50,000 per year from their RRIFs to support their lifestyle, and they have assumed rate of growth of 8%.

At life expectancy for Mr. and Mrs. Brown (age 92), their RRIFs will be worth approximately $400,000. On this amount, the tax payable will be $185,640 based on a 46.41% tax rate. If no planning is done, the Browns' estate will be responsible for paying a tax bill of $185,640. This means that the Browns' heirs will inherit a greatly reduced estate from what they expected.

However, if the RRIFs are insured, the annual cost of the insurance to the Brown's is $3,724, and the full value of the estate is preserved at **$400,000**.

As you can see, through effective planning, the tax on these RRIFs can be immediately funded for an annual payment of a little more than 2% of the $185,640 potential tax bill.

As the saying goes, there are two certainties in life – Death and Taxes. And when these two combine, usually due to lack of proper planning, the tax implications on the investor can be severe. As much as you would like to, the fact is that you cannot avoid paying these taxes. Now having said that, there are techniques available in which people can structure how they want to pay these taxes and perhaps pay less, but the bottom line is they must be paid in one form or another.

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