

Death of a TFSA Holder: Quebec and the Rest of Canada

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The tax-free savings account (TFSA) was introduced by the 2008 Federal Budget, effective 2009. Under current legislation contained in the *Income Tax Act*,¹ residents of Quebec are subject to a particular tax disadvantage when a TFSA is transferred to a surviving spouse or common law partner (hereinafter, a "surviving spouse").

The disadvantage arises in part from Quebec legislation concerning asset transfers on death. Perhaps because of its civil law tradition, or because its probate fees are negligible, the general rule in Quebec is that assets, including TFSAs, are transferred on death only through the estate, usually by a will bequest.² This is in contrast to the common law provinces, each of which has recently passed legislation aimed at allowing TFSAs to transfer on death either through the estate, or by written instrument made outside of a will that designates the recipient of benefits (hereinafter, a "beneficiary designation").³

If a TFSA is to be transferred to a surviving spouse, then the TFSA provisions contained in the Act are more tax-wise when the recipient of benefits is named by a beneficiary designation in a TFSA arrangement, rather than by will. This is because under such a beneficiary designation, the TFSA is automatically transferred to a person referred to in the Act as a "successor holder," which firstly simplifies the transfer, and secondly avoids post-mortem taxation of any income or increases in value under the TFSA. In contrast, under a will bequest the surviving spouse is not a successor holder under the Act but can contribute into his or her own TFSA the balance of the assets of the TFSA of the deceased taxpayer. In its 2008 "Questions and Answers about Tax-Free Savings Account" to TFSA issuers, the Canada Revenue Agency (CRA) commented as follows on the less advantageous tax treatment to the surviving spouse of TFSA assets transferred by will bequest rather than by beneficiary designation:

"The arrangement is deemed for certain provisions of the Act to

continue to be a TFSA until the end of the year following the year in which the holder dies or when the trust ceases to exist, if earlier. The main effect of this deemed rule is that the trust continues to maintain its tax-exempt status during this exempt period.

"Any payments made by the trust to the beneficiary during this exempt period are required to be included in the beneficiary's income to the extent that the payment represents the distribution of income earned on, or appreciation in the value of, the trust's property during the exempt period. This payment will have to be reported on a T4A as 'other income.'

"If the TFSA still exists after the exempt period, the trust will be taxable from that point forward and will be treated as having disposed of, and reacquired, its property for its FMV at that time. The issuer will be required to file a T3 *Trust Income Tax and Information Return* for every year beyond the exempt period that the estate remains unsettled.

¹ R.S.C. 1985, c.1 (5th Supp.) (the "Act").

² Article 1819 of the *Civil Code of Quebec*. One common exception is that proceeds of certain life insurance policies and insurance and trust company annuities can be transferred by beneficiary designations made outside of a will. See *Bank of Nova Scotia v. Thibault*, [2004] 1 S.C.R. 758.

³ For example, see for Ontario, Regulation 203/09 made under the *Succession Law Reform Act*, R.S.O. 1990, c.S.26, for British Columbia, ss. 49(1) and (2) of the *Law and Equity Act*, R.S.B.C., 1996, c. 253, and for Alberta, Regulation 228/2008 made under the *Trustee Act*, R.S.A. 2000, c. T-8.

"Under certain conditions and limits, the survivor may contribute an amount into their own TFSA without affecting their own TFSA contribution room. One of the conditions is that the survivor must designate these contributions as exempt contributions by filing with the CRA a prescribed form within 30 days of making the contribution. In addition, the contributions must be made within the end of the year, after the year of death of the deceased spouse. Upon receiving the prescribed form, CRA will disregard these contributions in the calculation of the TFSA room limit. These contributions must be reported by the financial industry as regular contributions."

Hence, the less advantageous tax treatment is that income and increases in fair market value under the TSFA during the post-mortem period up until the TSFA being paid out to the surviving spouse as referred to in the CRA's abovementioned comment, will be taxable simply if the beneficiary is not named in a beneficiary designation (pursuant to paragraph 12(1)(z.5) and subsection 146.2(9) of the Act). This approach contrasts with the regime applicable for RRSPs, which is tax neu-

tral as to the method of naming beneficiaries. Under the RRSP regime, where an annuitant of an RRSP dies before the plan matures, the amount received as a refund of premiums under paragraph 146(1)(h) of the Act can be rolled over to the surviving spouse's RRSP under paragraph 60(1) of the Act, and it does not matter whether the surviving spouse's entitlement arises by will, by a beneficiary designation under the RRSP or pursuant to an election of the surviving spouse and the legal representative of the deceased under subsection 146(8.1) of the Act.

In addition to this particular disadvantage, a further disadvantage that occurs when the surviving spouse is not named in a beneficiary designation is that the risks and consequences arising from a fluctuation in the value of the deceased's TFSA between the date of death and the date of final distribution of the TFSA, are borne by the surviving spouse. This is because the "exempt contribution" (as defined in subsection 207.01 of the Act) to the TFSA of a surviving spouse cannot exceed the lesser of the fair market value of the TFSA of the deceased at the time of death, or the payment made to distribute (within the calendar year which begins after the TFSA

holder dies) the TFSA of the deceased. Thus, the further disadvantage is that an increase in the value of a TFSA between the date of death and the date of the above-mentioned final distribution of the TFSA cannot be contributed to the surviving spouse's TFSA (nor can any decrease in the value of a TFSA during that period be carried back and deducted on the deceased's final tax return).

On Oct. 16, 2009, Minister of Finance Jim Flaherty announced technical amendments to the TSFA legislation.⁴ It is unfortunate that the announcement did not include any proposals to fix the less preferential tax treatment afforded to the surviving spouse of TFSA assets that are transferred by will bequest rather than by direct beneficiary designation.

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⁴ Canada, Department of Finance, "Government of Canada Proposes Technical Changes Concerning Tax-Free Savings Accounts," Oct. 16, 2009.