Beneficiary designations: A compelling case for keeping them updated

Understanding the how and why of beneficiary designations is an essential part of your financial strategy. The following case illustrates what can go wrong if beneficiary designations are not updated.

Jane's spouse recently passed away. She called her spouse's financial institution to find out what she would need to do to receive the proceeds of his Registered Retirement Savings Plans (RRSPs). She assumed she would need to provide a copy of the death certificate and perhaps the Will, and then the process of transferring the proceeds into her own RRSP would begin.

But no. There was a hitch. She was told her spouse's ex-wife was the named beneficiary on the accounts and that the woman he'd not been married to for over a decade would be receiving the RRSP proceeds. There must be a mistake. She was certain of it. As part of the divorce agreement, her husband and his ex-wife had signed away rights to each other's assets. She was sure her husband's Will left everything to her. Wasn't that enough to ensure she received the RRSP proceeds that were not included in the will?

Jane sought the advice of an estate planning professional. After asking all the relevant questions and reviewing the documentation, they told her there was nothing she could do to fix it. Her husband had not updated his beneficiary designations and while the divorce agreement said he was not obligated to give his ex-wife any assets, by not updating his beneficiary designation he had essentially voluntarily done so. But the bad news didn't stop there. Because the proceeds were not passing to his current spouse, his estate would be responsible for the tax on the value of the RRSP.

So, not only was Jane not going to receive the proceeds of the RRSP, but other assets would also need to be liquidated to pay the nearly 50% tax on the RRSP's value. She was devastated that her spouse had left her in this situation.

The example of Jane and her deceased spouse's retirement accounts show how outdated beneficiary designations can inadvertently cause additional pain and confusion for already grieving family members. However, many people are unaware of the rules and implications of these seemingly straightforward aspects of their financial strategy.

Transferring assets via your Will

Your will is one of the most important documents included in your estate plan. At minimum, your will should name your executor (liquidator in Quebec) and outline your wishes. It can go beyond naming beneficiaries and how you'd like your assets to be distributed. A will can include timelines and conditions on which distributions are made and include powers provided to your executor to aid in their task of implementing your wishes. If you don't have a valid will, the court will appoint an executor (in Quebec your heirs will be become your liquidators) and your estate will be distributed according to your province's intestacy provisions.

Beneficiary designations in a will are not limited to spouses; and include family, friends, or charitable organizations. Some provinces may allow you to specifically exclude individuals, whereas other provinces will allow spouses and children to challenge your distribution intentions if they feel inadequately provided for.

There are important ‘trigger’ events to consider upon which you should have your estate plan reviewed by a professional. Two such events are marriage and divorce. Depending on the province you live in, marriage can revoke your will whereas in other provinces it might not. The same goes for divorce. The provincial statutes governing wills are reviewed and updated regularly.

Probate is a legal process to validate the last will of the deceased and confirm the authority of an executor to act on behalf of the estate. Assets distributed through your will are subject to probate fees, also referred to as probate tax or estate administration tax. Depending on where you live, probate fees can be up to 1.5% of the estate’s value. Also, once your will is probated it becomes public record, meaning anyone can look up your will to see how your assets were distributed.

Since your will can provide instructions beyond asset distribution, there are situations where transferring assets through your will is preferable to using a direct beneficiary designation. Some examples are when utilizing testamentary trusts for minor children, disabled beneficiaries, or beneficiaries that you may have concerns about receiving large lump-sum inheritance. It is important to discuss these wishes with your estate planning professional.

Transferring your TFSA, RRSP, RRIF, or Life Insurance upon death

Depending on where you live[1], certain assets can be transferred directly to a beneficiary, outside of your will by naming a beneficiary directly. Further, not all “beneficiary designations” are created equal. Depending on the type of registered account you have and applicable provincial rules, you may have the opportunity to name a beneficiary, a contingent or alternate beneficiary, a successor holder or a successor annuitant. Let’s review the types of beneficiaries that can be named on each type of plan:

TFSA beneficiary designations

A Tax-Free Savings Account (TFSA) allows two types of designations: beneficiary and successor holder. Only your spouse or common law partner may be named a successor holder. If you die with this kind of designation in place, your TFSA continues with your surviving spouse simply replacing the original owner. Even if your surviving spouse has his or her own TFSA and no available contribution room, the investments in the successor account enjoy tax-free status in the hands of the new owner.

The other type of designation is a beneficiary. If you have a TFSA with a named beneficiary, then upon your death the investments pass to the named individual(s). Any income earned on the investments between the date of death and the time the funds are transferred to your beneficiary are subject to tax. If your beneficiary has enough available TFSA contribution room of their own, they could contribute the funds received to continue sheltering the funds from tax. Alternatively, they could contribute the funds to their RRSP if they have RRSP contribution room available to continue tax-deferral. If there is no existing TFSA or RRSP contribution room, they would need to wait until additional room became available. In the meantime, the assets would be exposed to tax. If a spouse is named as “beneficiary,” there are steps they can take to get the “successor holder” treatment, but it is a far more involved process.

RRSP beneficiary designations

Registered Retirement Savings Plans (RRSPs) only permit one type of designation: beneficiary. If the named beneficiary is your married or common-law spouse and the funds are transferred into his or her own registered account, no tax will be payable on the funds unless and until they are subsequently withdrawn. Similarly, if the funds transfer to a Registered Disability Savings Plan (RDSP) for the benefit of your financially dependent mentally or physically disabled child or grandchild, tax continues to be deferred. Finally, if funds are transferred to your minor beneficiary the funds can either be taxed in their hands or used to purchase a term certain annuity to age 18. But to the extent the funds transfer to someone other than your spouse or financially dependent child or grandchild (or don’t flow into such beneficiary’s RRSP, Registered Retirement Income Fund (RRIF) or RDSP) the full value of the RRSP will be taxable in the deceased’s year of death.

In some cases, it may make sense to name your estate as the beneficiary of your RRSP, rather than naming a direct beneficiary. Some examples would be to make sure the tax bill associated with the value of your RRSP can be paid from the RRSP proceeds and not some other asset. Or when you’re leaving the proceeds to your minor beneficiary or someone who would benefit from the protections of a trust.

*In Quebec, direct beneficiary designations are limited to insurance products and certain types of annuities. As a result, some of the information discussed in this article may not apply to Quebec residents, who may need to address certain accounts in their wills.

RRIF beneficiary designations

Registered Retirement Income Fund (RRIF) provide two beneficiary options: beneficiary or successor annuitant. Like the “successor holder” on a TFSA, only your spouse or common law partner can be named “successor annuitant” of a RRIF. The investments are transferred “in kind” (as is) to your surviving spouse who then continues as the owner of the account. There is no immediate tax liability and your surviving spouse will receive the RRIF payments going forward. If your successor annuitant transfers the funds into their RRSP, there is no impact to their contribution room. Other tax deferral options that exist for RRIFs are similar to those for RRSPs discussed above. As for naming a beneficiary, the rules are the same as those under an RRSP.

FHSA beneficiary designations

First Home Savings Account (FHSA) provides two beneficiary options; successor holder and beneficiary. Like the TFSA, only your spouse or common law partner can be named the “success holder”. The options with respect to the transfer of funds in the FHSA is dependent on whether the named successor holder qualifies to open an FHSA account in their own right.

If your spouse or common-law partner is named as a successor holder and they are eligible to open an FHSA, they become the new owner of your FHSA upon your death. This would not affect their own FHSA contribution room. If your surviving spouse/partner is not eligible to open an FHSA at the time of your death, they can transfer the funds in the FHSA to an RRSP, RRIF, or pre-existing FHSA if they have one, or receive the funds as taxable income.

You can also name your spouse or common law partner as a beneficiary rather than as a successor holder. In this case, your spouse/partner cannot become the new holder of the FHSA. Instead, they can transfer the funds in the FHSA to an RRSP or RRIF, or receive the funds as taxable income.

If you name someone other than your spouse or common-law partner as beneficiary, the funds they receive from your FHSA upon your death are considered income and taxed in their hands.

Life insurance beneficiary designations

In the absence of a named beneficiary, life insurance proceeds are typically paid to your estate. This may be desirable in some situations, for example if there are additional instructions in your will to use the insurance proceeds to fund a testamentary trust. However, when left to your estate, insurance proceeds may be subject to probate fees, and may be exposed to potential creditor claims. On the other hand, when there is a named beneficiary on a life insurance policy, the proceeds will flow directly to that named beneficiary and will not be included in your estate. This presents several key advantages in terms of estate administration efficiency, probate minimization, creditor protection, and privacy.

Other types of accounts and considerations

Other types of accounts, such as locked-in plans, segregated funds, and registered pension plans, all have distinct rules about beneficiary designations as well. Knowing your options is critical to making the best choice for you. What does it mean to name an irrevocable beneficiary? What impact does naming a beneficiary have on creditor protecting the registered plan or insurance policy? What’s the appeal of being able to name a beneficiary on a segregated fund? Also, does your investment allow you to name an alternate or contingent beneficiary? If so, you may wish to consider naming an alternate or contingent beneficiary in the event your primary beneficiary predeceases you.

We can help

It is important to review beneficiary designations on your registered plans periodically with an Edward Jones advisor to ensure they reflect your wishes.
We recommend reviewing your designations as part of your regularly scheduled review.
In between those reviews, make sure you’re sharing important life events such as marriage, becoming common law, separation and divorce so your advisor can help identify when it may be appropriate to make a change.

Edward Jones, its employees and financial advisors are not estate planners and cannot provide tax or legal advice. You should consult your estate-planning attorney or qualified tax advisor regarding your situation.
The illustration is for example purposes and does not reflect the experience of an actual client.

