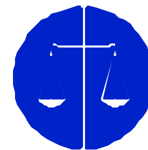

THE CANADIAN BAR ASSOCIATION
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The Voice of the Legal Profession
La voix de la profession juridique

February 2, 2005

Catherine Cloutier
Chief, Deferred Income Plans
Tax Policy Branch
Finance Canada
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Ms. Cloutier:

Re: Rollover of RRSPs and RRIFs to a Trust for Spouses and Disabled Financially Dependent Children

Thank you for meeting with me in October 2004 to discuss the National Wills, Estates and Trusts Section (the CBA Section) proposal for a rollover of RRSPs and RRIFs to a trust for spouses and a trust for disabled financially dependent children.

The CBA Section values the opportunity to enter into constructive dialogue with Finance Canada about legislative reforms under the *Income Tax Act.* In our letter to Finance Canada of October 19, 2004, we proposed:

- The rollover of an RRSP or RRIF to a trust for a spouse (including a common-law partner).
- The rollover of an RRSP or RRIF to a trust for a financially dependent child or grandchild.

The CBA Section has now reviewed the proposal further in light of the questions you raised in our meeting. Some of the concerns you expressed include:

1) The proposal might allow an unwarranted deferral of the tax on an RRSP, and taxpayers would be able to build up a larger RRSP for the eventual distribution to the children of the deceased than if the RRSP were left absolutely to the surviving spouse. While the same result occurs when an RRSP is rolled over absolutely to a surviving spouse, under the current rules, the spouse would have total control over the RRSP and would be entitled to make taxable withdrawals at any time.

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2) The social policy behind allowing a rollover of an RRSP to a spouse is to provide retirement income for the surviving spouse. Finance Canada was concerned that if the RRSP were held in a trust, the spouse might not have access to the capital until age 69, and then only be entitled to the minimum withdrawals required to be paid from a RRIF. When the RRSP is rolled over absolutely to the spouse, the spouse normally has access to the capital and can withdraw funds from the RRSP at any time and access more than the minimum RRIF payments, if needed.

You sought some assurance that the capital of the funds would be available to the surviving spouse. Without restrictions, the testator could impose conditions on the trustee that would prevent encroachment on capital.

PROPOSED RULES FOR ROLLOVER TO SPOUSE TRUST

In our view, Finance Canada's concerns can be met by designing the rules for a rollover to a spouse trust to meet the social objectives:

1) The proposal should operate only on death, either through a will or by a beneficiary designation which creates a spouse trust. It is important that both these alternatives be available. An important aspect of estate planning is probate avoidance, which can be achieved through a beneficiary designation filed with a financial institution. Like a will, such a designation is testamentary in nature in that it is dependent on death for its effect. Designating a spouse trust as a beneficiary would of course have to be carefully drafted to ensure that the terms of the trust comply with the requirements of the *Income Tax Act* as outlined in our proposal.

   The court should also be able to establish this type of trust by an order under dependant relief legislation. The *Income Tax Act* currently allows the court to correct or establish a qualifying spousal trust "under any law of a province that provides for the relief or support of dependants."[1]

2) All funds withdrawn by the trustee from the RRSP or RRIF must be paid to the surviving spouse and taxed in the spouse's hands, so the spouse could not leave income in the trust and allow it to be taxed at the trust's rate of tax.

3) A trustee must have control over the management of the RRSP or RRIF. If the spouse were given control over encroachments on capital, it would be the same as an absolute rollover of the RRSP to the spouse. The major estate planning problem we are trying to solve with our proposal is to allow deceased spouses to preserve capital in RRSPs for the benefit of the children from their first marriage, while encouraging them to provide support for the surviving spouse.

4) A trustee must have the ability to encroach on the capital of the RRSP or RRIF for the benefit of the surviving spouse. Otherwise the deceased spouse might place restrictions on the

[1] See section 248(9.1) of the *Income Tax Act*.

trustee's power of encroachment, and might even prevent the trustee from paying anything but the minimum RRIF payments to the spouse. The CBA Section suggests that, to roll over an RRSP or RRIF to a trust for a spouse, the trustee must be entitled by the terms of the trust to encroach upon the capital of the RRSP or RRIF for the proper support of the surviving spouse. To achieve the estate planning goals of this proposal, the trustee must have discretion to encroach on capital, not the requirement to do so. In this manner, the trustee will have a fiduciary duty to exercise the trustee's discretion in the best interests of the surviving spouse.

LEGISLATIVE PROTECTION FOR SPOUSE

Finance Canada expressed some concerns about recourse if the surviving spouse did not have sufficient access to the RRSP or RRIF. There are adequate remedies in provincial or territorial law:

a) Dependant Relief Legislation

Each province and territory has legislation that enables a surviving spouse to apply to the court for a greater share of the estate if the testator has not adequately provided for the survivor's support. The court can change the will of the deceased and provide a greater share of the estate to the spouse. The court can even order that the RRSP or RRIF be transferred absolutely to the surviving spouse; in other words, revoke the trust. The court could also vary the terms of the trust to ensure that the trustee is not unduly restricted from encroaching on the capital of the RRSP or RRIF in favour of the spouse.

b) Matrimonial Property Legislation

In most provinces and territories, the court has the power to divide the matrimonial assets of spouses on the death of one of them. This is governed by two kinds of law:

i) In some provinces, such as Ontario, death is a triggering event under matrimonial property legislation. The court can award property to a surviving spouse who has not received half of the matrimonial property during life or on the death of the first spouse. The Ontario legislation is a model for the other provinces in this regard. Alberta, for example, is considering similar legislation.

ii) The Supreme Court of Canada held in *Tataryn v. Tataryn Estate*[2] that, when considering a claim under dependant relief legislation, the court must take into account the legal rights of a spouse (statutory and common law) and award the portion of the matrimonial assets to which the spouse would have been entitled in a divorce. This has the effect of making death a triggering event under matrimonial property legislation.

c) General Trust Law

Trustees have a duty to exercise their discretion under a trust in an even-handed manner. A trustee is an officer of the court and becomes subject to all of the obligations of a

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[2] [1994] 2 S.C.R. 807.

> fiduciary. Trustees who do not exercise their discretions appropriately run the risk of being removed by the court.

In our experience, resort to the courts is rarely necessary. Well-advised trustees understand their duties and exercise their discretion in good faith. Claims under dependant relief legislation are usually settled in negotiations with the beneficiaries. Provincial and territorial estate law is well developed and serves beneficiaries well. The CBA Section is confident that the interests of surviving spouses are protected under general estate law in all the provinces and territories.

OTHER ISSUES

Taxation of the RRSP or RRIF on the Death of the Second Spouse

The CBA Section proposed that, on the death of the second spouse, the RRSP or RRIF would be taxed in the trust at the trust's marginal tax rates. Finance Canada thought this would yield less tax than if taxed in the hands of the surviving spouse and suggested that the trust and the estate of the surviving spouse be jointly and severally liable for the tax. The difficulty with this solution is that the estate of the surviving spouse would pay the tax, but the children of the first marriage would get the money from the RRSP or RRIF. This would be unfair to the beneficiaries of the surviving spouse's estate because it reduces the size of the estate and the estate would not have access to the RRSP or RRIF asset to pay the tax. The estate of the first spouse to die (the trust) must be primarily liable for payment of the tax.

One alternative we discussed is to determine the applicable tax rate by reference to the surviving spouse's terminal tax return and then taxing the trust at this rate. One of the problems with this approach is determining the applicable tax rate. In second marriage scenarios, the children of the first spouse and those of the second spouse may not be cooperative. It may therefore be difficult to discover the marginal tax rate of the surviving spouse. Further, what tax rate should be used? Should it be the highest marginal tax rates of the surviving spouse, or should it be a blended rate? To avoid these issues, it might be easier to tax the RRSP or RRIF in the trust. We believe that the amount of tax payable will be roughly the same as if it were taxed in the hands of the second spouse.

Interpretation 9528305 – Irrevocable Beneficiary under Insured Registered Retirement Income Fund

You provided interpretation 9528305 as an example of an existing product available to achieve the same result as the CBA Section's proposal. As we understand this product, it is possible to register a life insurance company RRIF in the name of a primary annuitant and a successor annuitant. The primary annuitant is the only one entitled to payments during his or her life, and on death, the successor annuitant receives the RRIF payments for life. At the time of purchase, the primary annuitant irrevocably designates his or her children as the beneficiaries of the RRIF. On the death of the successor annuitant, the RRIF is paid to the surviving children. Interpretation 9528305 states that this arrangement can satisfy the conditions for registration under the *Income Tax Act.*

While we agree that this product achieves some of the goals of our proposal, we have some concerns:

- The parties are restricted to a life insurance company product. To the best of our knowledge, banks and other financial institutions cannot provide this product, which does not provide a level playing field amongst financial institutions. In any event, many people prefer not to buy life insurance company products with their retirement savings.
- The use of the funds is controlled by the children of the primary annuitant. Provincial insurance statutes provide that when a beneficiary is designated irrevocably, no changes to the contract may be made without the consent of the beneficiaries. For example, section 575(1) of the *Alberta Insurance Act* reads as follows:

  > An insured may in a contract or by a declaration, other than a declaration that is part of a will, filed with the insurer at its head or principal office in Canada during the lifetime of the person whose life is insured designate a beneficiary irrevocably, and in that event the insured, while the beneficiary is living, must not alter or revoke the designation **without the consent of the beneficiary** and **the insurance money is not subject to the control of the insured or of the insured's creditors and does not form part of the insured's estate**. *(emphasis added)*

  This means that if the spouse requires an encroachment for support, the children can deny the encroachment. The children can also veto changes to the investments in the RRIF. The court has no power to change the arrangement under dependent relief legislation because this RRIF does not form part of the insured's estate (life insurance passes to the beneficiaries and does not form part of the estate; the court only has power to award a greater share of the "estate").

  Note also that these children are not trustees. They owe no fiduciary duty to the surviving spouse. They may withhold their consent to encroachment without any recourse by the surviving spouse. They are not subject to the supervision of the court.

- This product can only be sold as a RRIF. Our solution extends also to RRSPs. It is important that younger spouses be allowed to place their RRSPs in a trust of this nature. The surviving spouse will usually want the RRSP to grow until needed at retirement. This accords with what is allowed under current tax law with a rollover to a surviving spouse.

U. S. Estate Tax

A U.S. citizen is currently subject to U.S. estate tax on his or her worldwide estate at death. The current top rate of tax is 48%. This tax applies regardless of where the U.S. citizen resides. If a Canadian resident who has an RRSP or RRIF is married to a U.S. Citizen resident in Canada, this spouse would normally be designated as the beneficiary of the RRSP or RRIF. The goal is to access the deferral of tax available on a transfer at death to a spouse. However, the effect is that the balance of the RRSP or RRIF remaining on the surviving spouse's death will form part of his or her taxable estate for purposes of the U.S. estate tax. If instead the RRSP or RRIF passes to a trust for the surviving U.S. citizen spouse which permits the spouse to receive all the income and capital for his or her "maintenance, support, health and education" (to a defined standard under

U.S. tax law) then the RRSP or RRIF will not be subject to U.S. estate tax on the death of the second spouse. This is because for U.S. tax purposes the interest of the surviving U.S. citizen spouse in the trust has a value of nil at his or her date of death. The bottom line is that there is a real benefit in implementing a trust to receive an RRSP or RRIF where the surviving spouse is a U.S. citizen.

The U.S. estate tax is a severe penalty for U.S. citizens living in Canada, many of whom are also Canadian citizens. The ability to rollover an RRSP or RRIF to a spouse trust would greatly benefit Canadians.

Rollover to a Trust for Financially Dependent Children and Grandchildren

We did not have much time in our October meeting to discuss the CBA Section proposal to allow a trust for financially dependent children and grandchildren to hold an RRSP, rather than just the ability to purchase an annuity. We believe that an annuity is too restrictive for this purpose and that allowing the trust to purchase an RRSP would provide needed flexibility. First, in a time of low interest rates, the return of an annuity for the disabled child is too low. Second, the trustees need the flexibility to withdraw additional funds from time to time for the special needs of the disabled child, such as:

- health care - operations out of Canada
- purchase of a residence
- purchase of health care equipment such as wheelchairs or beds.

Third, funds in an RRSP held in a trust for a disabled child should be allowed to accumulate tax-free because the trust represents a safety net for the child.

Parents of disabled children are motivated to provide for their children and the most useful tool is a discretionary trust. We should encourage these parents to provide sufficient funds for the proper support of their dependent children. Allowing a rollover of an RRSP to a trust for dependent children allows a deferral of tax on the same basis as the current absolute rollover to a dependent disabled child, but it ensures that the funds are properly managed by a trustee.

Technical Advisory Committee On Tax Measures For Persons With Disabilities

The Report of the Technical Advisory Committee on Tax Measures for Persons with Disabilities issued in December 2004 included the following recommendation:

> The government review the RRSP or RRIF rules in order to allow additional flexibility in respect of a deceased's RRSP or RRIF proceeds left to a financially dependent child or grandchild with a disability. Such provision should include allowing these proceeds to be rolled over to a discretionary trust for that individual, provided that no person other than the disabled beneficiary may access the income or capital of the trust during his or her lifetime. The revenue cost of this measure is small.[3]

[3] At page 99. This recommendation arose out of a submission by the Planned Lifetime Advocacy Network (PLAN).

CONCLUSION

The main object of our proposal is to provide spouses in a second marriage or common law relationship an estate-planning tool that can support the surviving spouse as well as preserve the estate for the benefit of children from the first marriage. The spousal trust is well established in estate law and income tax law. The CBA Section is simply asking that this important estate planning tool be extended to RRSPs and RRIFs.

Under the current tax rules, spouses in second marriages sometimes designate their children rather than their spouse as the beneficiary of their RRSP or RRIF because this is the only way they can be assured that the capital of their estates passes to their children from their first marriage. Some even go to the extent of transferring RRSP investments to life insurance company products, so that the RRSP becomes creditor proof, even from their spouse. If these spouses could use a spouse trust in this circumstance, we believe that the surviving spouse would be better supported and less litigation would result.

We also suggest that the *Income Tax Act* be amended in a manner similar to that suggested for spouses to allow a parent's RRSP or RRIF to be rolled over to an RRSP, RRIF or annuity held in a trust for a disabled child. Our proposal would work exactly the same as the proposal for a trust for a spouse.

Thank you for meeting with us and for your continued attention to this matter. We would be pleased to discuss the proposals with you at greater length.

Yours truly,

(Original signed by Trevor Rajah on behalf of Philip J. Renaud)

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