TAX AND ESTATE CONCERNS AT DIFFERENT LIFE STAGES

CI GLOBAL ASSET MANAGEMENT

The responsibilities of a financial advisor often extend beyond rates of return and can include tax, retirement and estate planning conversations that can lead to deeper relationships with clients. Understanding these aspects of a financial plan provides an opportunity to learn more about a client's family, their values and priorities, and how each impacts the management of assets in life and at death.

The purpose of this article is to discuss some common tax, retirement and estate planning concepts financial advisors might face when working with different types of clients. While it can benefit advisors both young and old, this article was written with new advisors in mind and is meant to serve as a brief overview of topics they might encounter when meeting with clients.

It is not uncommon for financial advisors to have the following types of clients:

- Young professionals
- Middle-aged couples
- Retirees

For each category, there are a number of tax, retirement and estate planning concepts to consider.

YOUNG PROFESSIONALS

Young professionals don't often consider retirement a priority. Instead, they often spend their time and resources paying off postsecondary debt or planning for significant purchases, such as a car or a house. This creates an opportunity to talk about debt and how to best save for significant purchases.

The tax implications of debt (and more specifically, the deductibility of interest costs) can be a significant factor in determining how quickly certain debts should be paid off versus other similar debt. Of course, debt often carries a cost – that is, interest payable on the debt. This cost, however, can be partially offset if the cost is tax-deductible.

The general rule, under section 20(1)(c) of the federal Income Tax Act (ITA), is that interest on a loan is tax-deductible if the loan is used to earn income.[1] Where two loans are identical in all respects other than the deductibility of related interest, the loan with nondeductible interest is more expensive. Thus, when compared to a loan with deductible interest, it often makes sense to pay off the former first. Consider the following:

- Jessica has two outstanding loans, $15,000 each.
- One loan was used to purchase a personal-use, non-income producing vehicle, and the second was used to purchase a dividend paying stock within a non-registered investment account.
- Each loan has an 8% annual interest cost; interest on the vehicle loan is non-deductible whereas interest on the stock loan is taxdeductible as the stocks have the potential to pay dividend income.
- Jessica wants to know the cost of each loan for the current year. Her marginal tax rate (MTR) for the year is 35%.:

Loan amount and type	$15,000 car loan	$15,000 stock loan
Interest cost (8% annually): (A)	$1,200	$1,200
Tax savings from deductible interest (35% MTR): (B)	Nil	$420
Cost of loan(current year): (A-B)	$1,200	$780

It should be noted that deciding which loan to extinguish first becomes vastly more complicated when existing loans have different outstanding amounts and interest rates.

When it comes to saving for significant purchases, young professionals often consider investing available cash in registered accounts. More specifically, the question asked of

[1] For these purposes, "income" does not include capital gains.

many advisors is "Should I invest in a Tax-Free Savings Account (TFSA) or a Registered Retirement Savings Plan (RRSP)?" Each of these accounts offer distinct advantages based on current income, expected future income and financial goals. From a tax perspective, if an individual expects to withdraw money in the future when subject to a higher marginal tax rate (e.g. when earning a larger salary or self-employment income), the TFSA is normally the better vehicle. On the other hand, if the individual expects to withdraw their money when taxed at a lower rate (i.e. in retirement), the RRSP is the better account. See the following example:

- Thomas is a new graduate, age 22. He recently accepted a junior role in his area of study.
- Thomas's marginal tax rate is currently 20%. He expects his employment income to grow over time and plans to withdraw his money when at a 45% tax bracket.
- Thomas has $6,000 from employment income to contribute to either an RRSP or TFSA, and he wants to know which option makes the most sense from a tax perspective.

Tax-bracket[i] – Low to High		
	RRSP	TFSA
Pre-tax investible income from employment	$1,200	$1,200
Tax at 20%	Nil[ii]	$420
Net contribution	$1,200	$780
Growth – 6% over 20 years[iii]	$19,243	$15,394
Tax on withdrawal at 45%	$8,659	Nil[iv]
Net cash at time of withdrawal	**$10,584**	**$15,394**

[i] At time of contribution and withdrawal.
[ii] No tax due to RRSP deduction (assumes available RRSP deduction room).
[iii] No withdrawals during growth period.
[iv] No tax due to tax-free withdrawal.

In the scenario above, the TFSA is the more desirable option as it produces a greater after-tax amount on withdrawal. However, if Thomas expects his tax rates to go from high (45%) to low (20%), investing through an RRSP would be the preferred choice:

Tax-bracket[i] – High to Low		
	RRSP	TFSA
Pre-tax investible income from employment	$6,000	$6,000
Tax at 45%	Nil[ii]	$2,700
Net contribution	$6,000	$3,300
Growth – 6% over 20 years[iii]	$19,243	$10,584
Tax on withdrawal at 20%	$3,849	Nil[iv]
Net cash at time of withdrawal	**$15,394**	**$10,584**

[i] At time of contribution and withdrawal.
[ii] No tax due to RRSP deduction (assumes available RRSP deduction room).
[iii] No withdrawals during growth period.
[iv] No tax due to tax-free withdrawal.

It should be noted that there are often exceptions to this rule. While the TFSA might work well for younger Canadians, such as those who are saving for their first home, the RRSP can provide tax deductible contributions while allowing up to $35,000 to be withdrawn tax free for the purchase of a first home. These rules, per the ITA's First-Time Home Buyers Plan (HBP), are subject to a 15-year repayment period and other conditions.

MIDDLE-AGED COUPLES

For 2018, middle-aged couples, particularly those between the ages of 45-64, formed the largest age demographic in Canada (Statista, 2019).

As such, it is imperative that advisors address the tax, retirement and estate planning needs of this group. While it is common for this demographic to experience cash-flow pressures due to the needs of children, significant household expenses (e.g. mortgage or renovations) or caring for aging parents, it is important for this group to understand the importance of planning for retirement.

Traditionally, retirement funding has often consisted of government benefits combined with a substantial pension from an employer-sponsored plan. However, because of the declining availability of defined benefit pension plans (DPSPs), many future retirees will have to look elsewhere

for their primary retirement income. Personal savings are becoming increasingly significant and clients need to be aware of this reality and plan accordingly. Whether this comes in the form of contributions to RRSPs, TFSAs or non-registered plans, advisors can work with middle-aged couples to determine future needs and plan to meet them. Clients should also understand that the ITA limits the amount that can be contributed to tax-advantaged accounts (e.g. RRSPs, TFSAs, registered pension plans and DPSPs) and, in order to level the playing field for all Canadians, contributions to one (e.g. registered pension plans or DPSPs) may result in a "pension adjustment" that will reduce available contribution room to another (e.g. RRSP).

Advisors should also understand and communicate to clients the importance of creating a will. While this is important for clients of all ages, whether it be minor children or recently blended families, middle-aged couples can face unique challenges at death if their intentions are not appropriately communicated. When an individual dies without a will, the individual is deemed to die "intestate." When this occurs, government legislation defines how the deceased's assets are to be distributed. In many cases, the deceased's married spouse (if any) is entitled to a defined share of the deceased's estate – often referred to as the "preferential share." Amounts in excess of the preferential share are normally divided between the spouse and children. While this distribution might be suitable for some couples, challenges can arise. They might include:

- Common-law partner might not inherit (or may be required to pursue other processes to win a share)
- Children might inherit directly, which can present problems in the case of minor, disabled or spendthrift children
- A surviving spouse may require the consent of the Public Trustee to deal with assets for minor children
- Acceleration of taxation as transfers to children do not normally occur on a tax-deferred basis
- No direction as to who the guardian(s) for minor children should be.

In addition, middle-aged couples often face changes in their family structure, whether it be a new child, new properties or a relationship breakdown. Whenever these significant shifts occur, advisors should remind and work with their clients to create or update their estate planning documents where necessary, including wills and powers of attorney. Failing to do so can result in unintended consequences and delays in the administration of assets.

RETIREES

Similar to young professionals and middle-aged couples, retirees have a number of tax, retirement and estate planning decisions to contemplate. One such decision is the best way to transfer certain registered assets (i.e. RRSPs, Registered Retirement Income Funds (RRIFs) and TFSAs) and life insurance proceeds to beneficiaries. With the exception of Quebec, which doesn't permit named beneficiaries on registered plans, provincial and territorial legislation allows for named beneficiaries on RRSPs, RRIFs and TFSAs. Accounts with named beneficiaries allow assets to bypass the estate of the deceased, which can avoid estate administration fees and complex estate settlements. The same is also possible for insurance contracts in all provinces and territories. The alternative is to not name a beneficiary on plan contracts and flow the assets through the deceased's estate to be governed by the deceased's will (or intestacy rules in the case of no will). Of course, there are advantages and disadvantages to both options, some of which are highlighted below.

Named beneficiaries on RRSP, RRIF, TFSA and insurance contracts – Advantages and disadvantages

Advantages	Disadvantages
▪ Avoids estate administration fees (i.e. probate)	▪ Can create inequitable distributions if RRSP/RRIF taxation at death is charged to and paid by the estate[i]
▪ Avoids complex estate settlements and related delays	▪ If beneficiary is a minor or not competent, proceeds may be paid to Public Trustee on behalf of the beneficiary
▪ Simpler to amend designation when required as opposed to having to update a will	▪ If beneficiary predeceases plan owner, contract designation does not provide for proceeds to pass to beneficiary's children on owner's death
▪ Can avoid creditors of the deceased's estate[ii]	▪ Designation not automatically revoked on marriage or divorce of annuitant

[i] Which is normally the case in the absence of a designation in favour of a spouse, common-law partner or financially dependent child.

[ii] Subject to exceptions.

Despite the opportunity to avoid probate fees (which at its most nationally is 1.7% for estates resident in Nova Scotia), it can often be more useful to flow assets through the deceased's estate by leaving the contract designation blank or naming "estate" as the beneficiary. Doing so allows for greater control after death, perhaps through the creation of a testamentary trust. Subject to the deceased's will, an estate designation can also provide for children or grandchildren of a beneficiary if the beneficiary predeceases the testator and permit the designation to be automatically revoked upon the testator's remarriage.

Retirees who are sensitive about tax might find it helpful to know that when they pass away, their tax bill for the year of death can spike dramatically. Given Canada's graduated tax rate system, it is not uncommon for Canadians to be taxed at lower tax brackets and rates while living, only to be subject to top tax rates in the year of death. This can happen because of the deemed sale of assets that occurs at the time of death. Where assets are not transferred to a spouse or common-law partner at death, appreciations in capital (i.e. non-registered assets) and the full value of RRSPs and RRIFs can create a large taxable income for the year of death and taxation at the top tax rate. To avoid this, clients can consider a tax-deferred rollover to a spouse or common-law partner, if any. During retirement, clients can also withdraw more than needed from RRSPs and RRIFs to be taxed at lower tax rates; excess money can be reinvested in tax-efficient TFSAs or non-registered accounts. If employing this strategy, clients should be mindful of income-sensitive benefits (e.g. Old Age Security) to ensure that a reduction does not occur.

Success as an advisor is often measured by one's ability to plan ahead and consistently satisfy their clients' needs. Whether your clients are young professionals, middle-aged couples or retirees, discussions in the areas of tax, retirement and estate planning can deliver value, uncover opportunities and deepen relationships.

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