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RRSPs, RRIFs and withholding taxes at death

The absence of withholding taxes can create unexpected consequences if no planning is done.

Withholding taxes don't normally apply to RRSP and RRIF proceeds paid to beneficiaries when the planholder dies. This may sound like good news, but it can also create complexities for families.

Why don't withholding taxes apply? The short answer: there is no such requirement under the Income Tax Act.

In Canada, payers of taxable income are normally required to withhold a certain amount of tax when the income is paid to recipients. The amount to withhold depends on the income type and the amount paid. There are exceptions to the rule, including payments of interest and dividends to Canadian residents.

RRSP withdrawals are normally subject to a withholding tax of up to 30% depending on the amount (for RRIFs, only amounts in excess of the RRIF minimum for the year are subject to the withholding).

When an RRSP or RRIF holder dies, they're deemed to have received the plan's value just before death. (One way around this is to transfer the plan to a spouse, common-law partner or financially dependent child or grandchild on a tax-deferred basis using certain registered plans.)

This results in taxable income for the deceased for the year of death.¹

We commonly see this when parents or grandparents die with RRSPs and RRIFs for which their children or grandchildren are beneficiaries. Where the beneficiaries are entitled by way of their designation on the RRSP/RRIF contract,² RRSP/RRIF issuers normally pay the proceeds directly to the beneficiaries free of withholding taxes, even though the amounts are taxable.

Consider the following example:

At the time of her death, Mae had \$400,000 in her RRIF. Her daughter, Grace, is the beneficiary as per the RRIF application. Mae also had a will in which she named her other two children, Jacob and Charity, sole beneficiaries of her estate. Mae's will made no reference to her RRIF.

Shortly after Mae's death, Grace approached the RRIF issuer and requested payment from the plan. The issuer paid Grace \$400,000 — there was no change in the value of the RRIF between the date of Mae's death and payment to Grace. A T4RIF was issued to Mae's executor requiring \$400,000 to be included as taxable income on Mae's terminal tax return for the year of death, payable by her estate. As a result, Grace received \$400,000 free of withholding taxes, while Jacob and Charity paid the taxes for the payment via a reduction of their entitlement from Mae's estate.

This example shows the importance of planning for taxes, especially where estate and registered plan beneficiaries are different.

At first blush, one might think that withholding taxes would apply to the \$400,000 payment to Grace given that the amount was taxable. After all, withholding taxes normally apply to RRSP withdrawals, and to RRIF withdrawals that exceed the yearly minimum amount. What, then, makes things different for payments made as a result of death?

When a beneficiary requests payment from the plan, as per Canada Revenue Agency technical interpretation #9931685, withholding tax doesn't apply to the date of death amount for the following reasons:

- Withholding tax normally applies to taxable amounts "paid" from RRSPs and RRIFs.³ In the case of death, the date of death amount, while taxable, is "deemed received." Thus, there is no payment to which withholdings apply.
- Where date of death amounts are taxed to the deceased, payments to beneficiaries are tax-free, so there is no requirement to withhold tax from them.

Exceptions to the rule apply in certain non-resident scenarios; namely, where the deceased was a non-resident at the time of death, and also where the named beneficiary is a non-resident and the payment is in respect of growth accrued in the RRSP/RRIF between the date of death and payout. In these situations, a non-resident withholding tax normally applies.

Outside of these scenarios, the absence of withholding taxes for RRSP and RRIF death settlements can create unexpected consequences if no planning is done.

Planning implications

While withholding taxes during one's lifetime can help to avoid surprise and hardship at tax-filing time, payments from RRSPs and RRIFs at death don't normally receive the same treatment.

Clients could consider life insurance to cover taxes or equalize entitlements for plan and estate beneficiaries. Alternatively, beneficiaries can be made consistent across all assets.

Discussing your clients' intentions with them and their families can help uncover potential conflicts and challenges.

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Notes

1 There is flexibility to tax the date of death amount in the hands of a spouse, common-law partner or financially dependent child or grandchild for the year of death provided they're a beneficiary of the asset.

2 In Quebec, RRSP and RRIF plan level designations aren't normally allowed; beneficiary designations are normally made by way of a will.

3 RRIF minimum amounts are an exception to the rule.