

## RRSPs: Do You Really Know Your Way Around?

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### Nature and qualification of the contract of annuity pursuant to the *Civil Code of Québec* (articles 2367 and ssq. C.C.Q).

#### Retirement Savings

Retirement savings may accumulate under various investment vehicles: self-directed RRSPs, mutual funds RRSPs, fixed-term annuity RRSPs, etc. There are as many financial products as there are institutions that offer them: trust companies, life insurance corporations, banks, investment dealers, etc.

Registration with fiscal authorities results in postponing the payment of taxes to a later date, but has no bearing on the character of the plan or the protection of funds accumulated therein.

Certain annuities take the form of regular deposits directly with the financial institution that holds the capital. This type of savings must be distinguished from the term or life annuity RRSP in which a trustee or a life insurer must intervene.

#### Retirement savings in the form of an annuity contract

A trust company or an insurance company manages the fixed term annuity contract. Insurance companies may also offer a life annuity contract.

The annuity contract, whether the fixed term or life, is comprised of two phases:

#### Accumulation Phase

The contributor entrusts the trustee or the insurer with capital. During this phase, certain contracts provide or allow for the partial or total withdrawal of the capital by the contributor.

#### Distribution Phase

Once the plan has matured, the trustee or the insurer periodically pays the annuity to the contributor or alternatively to a designated beneficiary, in the event the contributor deceases prematurely.

The courts have on many occasions determined whether such contracts respected the distinctive characteristic of an annuity contract. The most important essential element is the transfer of the capital from the contributor's patrimony to the trustee or the insurer. There must be an alienation of the contributor's capital in consideration of which a term annuity or a life annuity, if offered by a life insurer will be paid as of an age specified in the contract. The right to partial or total withdrawal in the accumulation phase may effect the character of the annuity.

#### Management of the RRSP contribution during life together

During marriage, civil union or de facto union, each spouse manages their personal patrimony.

The fact that the spouses are married, their matrimonial regime or the fact that they may or may not be governed by the provisions that relate to family patrimony does not modify the preceding statement.

Spouses are free to contribute to a RRSP of their choice. It is important to note that a

spouse, married or not, may contribute to his or her spouse's RRSP and benefit from the tax deductions thereunder. But beware: if the spouse who benefited from the deductions withdraws any amount during the three years following the contributions, the contributing spouse may possibly be subject to an income tax assessment.

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Spouses may withdraw amounts that they have contributed during their life together, without having to obtain the approval of the other. However, if the spouses are married<sup>1</sup> and subject to the provisions regarding family patrimony, a withdrawal made during the year preceding death, divorce or separation proceedings or perhaps even before, if there is evidence of bad faith, may give rise to a compensatory payment, that is, the payment of an amount representing 50% of the value of the contributions which would normally have been included in the family patrimony.

### What is the effect to the spouses' contributions to a RRSP following a breakdown?

The major distinction with respect to the treatment of the contributions following a breakdown resides in the nature of the union.

#### Unmarried partners?

The persons who are living in an unmarried relationship will retain their respective contributions following the breakdown, subject to the existence of a domestic partnership contract or a common-law contract providing for the partition of their RRSPs.

The domestic partnership or common-law contract allows those who chose not to marry and thus not to be submitted to certain obligations arising from marriage to agree on the devolution of their property before separation.

Such a contract like others between persons of full age becomes executory when confirmed by a Court.

### What happens to contributions of persons who are married or who live in a civil union...

#### ...and are subject to the provisions regarding family patrimony (Section 415 et ssq. C.C.Q.)

The contributions of married spouses are treated differently. Following a breakdown caused by death, or judgements of divorce or separation from bed and board, the spouses' contributions to a RRSP will be shared equally between them. It should be emphasized that only contributions during marriage will be included in the partition. Furthermore, only the contributions to a RRSP or to a pension plan are subject to partition, as well as the value of any other retirement savings instrument, including an annuity contract into which sums from any such plans have been transferred. Other retirement savings instruments are: an annuity contract, a registered retirement income fund (RRIF), a locked-in registered retirement savings plan (locked-in RRSP), a locked-in retirement account (LIRA) and a life income fund (LIF). Consequently, contributions to an education savings plan (ESP) or to a deferred profit sharing plan (DPSP), those made under supplementary retirement contracts for high-salaried employees, non registered annuity contracts, stock savings plans and life annuities acquired from an insurance company, are not subject to partition.

It is important to note that contributions made before marriage are not subject to partition. In the same manner, the interest from these contributions are not subject to partition following a marriage breakdown. Although it may be relatively simple to establish the value of contributions as at the date of marriage, it may be more difficult to trace the interest earned from these contributions, especially when the invested sums have been transferred to different financial products over the years. It is thus recommended to retain as much documentation as practicable which would constitute the best evidence on contributions and the interest therefrom.

Following a breakdown, the courts favour a partition in kind, that is to say that a spouse transfers part of his or her contributions to a RRSP to his or her spouse's own RRSP so that each spouse holds an equal amount for the partition period.

This transfer is effected by the completion of the T-2220 tax form, which allows for a rollover of contributions between spouses without fiscal impact. This form also allows for a transfer between unmarried partners, we must emphasize that these persons have no legal obligation to partition their contributions following a breakdown.

Although equal partition applies, as a general rule, to married spouses subject to the provisions regarding family patrimony, it is important to emphasize that in certain cases, an unequal partition may occur. Among other things, if the application of the law (being the equal partition) would result in an injustice to one of the spouses considering, for example, the bad faith of the other spouse. The court will have to rule upon such matters. The spouses may also agree on an unequal partition of the family patrimony, particularly RRSPs, in an agreement on accessory measures in the event of marriage breakdown.

Lastly, contribution to a RRSP made out of sums devolved by succession or gift will be deducted from the divisible net value of the matrimonial patrimony. In other terms, the spouse that has contributed from his or her inheritance will be able to recover these contributions to the extent that the value of the property (in this particular instance, the contributions to the RRSP) has not decreased. The recovery will however be limited to the net value of the property at the time of the separation or the commencement of proceedings.

<sup>1</sup> The comments made in this newsletter concerning the married spouses also apply to couples who are joined in civil union under the Act instituting civil unions and rules for establishing new filiation (S.Q. 2002, c. 6) that came into force on June 24, 2002.

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### ... and not subject to the provisions regarding family patrimony

Finally, spouses who are not subject to the provisions regarding family patrimony, for example, due to their opting out by notarial deed to the application of the family patrimony provisions before December 31, 1990, will have to refer to their matrimonial regime to determine the fate of the partition of their contributions to a RRSP. Under the regime of separation as to property no partition will take place. For spouses governed by partnership of acquests or community of property regimes, a partition will take place, subject to the provisions of law applicable to their matrimonial regimes.

## Financial planning

### Privilege of exemption from seizure

The law declares unseizable, except by the spouse of the contributor, the benefits payable to and the contributions made by an employee under a supplemental pension plan to which an employer contributes (section 553.7 of the *Code of Civil Procedure*). Pension funds transferred in an immobilized RRSP or in a LIF will generally benefit from the same protection from seizure under the laws applicable to the various pension funds.

However, the private pension plan to which only the employee contributes is not unseizable. As a rule, RRSPs constitute seizable property.

### What types of RRSPs are unseizable?

Only the RRSPs in the form of fixed term or life annuity contracts are exempt from seizure, when they conform to the requirements of the *Civil Code of Québec* in all respects.

Taking into account the diversity of contracts, it is sometimes difficult to distinguish between a contract that will protect the invested capital in case of financial hardship and a contract that will allow seizure from the creditors or the distribution of capital by a trustee in bankruptcy.

Each contract must be meticulously reviewed to determine if the capital is protected from seizure.

**During the accumulation phase of the retirement saving**, the exemption from seizure of the sums accumulated therein will be established by reviewing the clauses of the contract of annuity, the time of the deposits, of the withdrawals and their compliance with the provisions of the *Civil Code of Québec*.

Because of the diversity of the contracts and of each situation, there are many cases deserving with this issue. We should examine the following criteria:

- the relationship between the contributor and the beneficiary who will receive the annuity at the time of the contributor's death, and
- the alienation by the contributor of the accumulated capital in the hands of the trustee or the insurer.

The relationship between certain beneficiaries and the contributor may result in an exemption from seizure. The designation of a "privileged" beneficiary, being the spouse, a descendant, an ascendant or an irrevocable beneficiary, protects the accumulated capital (sections 2379, 2393 and 2458 C.C.Q.).

There must also be a true divestment from the contributor in favour of the trustee. During the accumulation phase of the capital, the contributor must part with the capital in exchange of which an annuity will be paid out to him upon maturity of the plan.

The consequence of this true divestment, is that the capital accumulated in the hands of the trustee or the insurer is no longer the property of the contributor. Thus, it cannot be seized.

However, the courts have held that the contributor's option to effect a partial withdrawal without terminating the saving contract itself may alter the nature of the contract and consequently affect the exemption from seizure of the capital. See: *Lacroix (Syndic de) JE-2001-271* and *Dans l'affaire de la faillite de René Croft* (1988) R.J.Q. 1917.

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The participation of the contributor to the management of the funds could also affect the required divestment. The most common example is the self-directed RRSP in which the contributor gives investment instructions, is responsible for investment selection and decides if the trustee must acquire, sell or retain an investment. The control retained by the contributor on the capital would be incompatible with the divestment of the capital that constitutes an essential element of the annuity contract.

The Court of Appeals has so decided in the *Scotia McLeod et Banque de Nouvelle-Écosse et Thibault* (REJB 2001-25542). The Court held that a self-directed RRSP where the contributor has the right to withdraw his assets in part does not conform to the divestment requirements of capital in favour of the trustee and does not constitute an annuity and is therefore seizable. Leave to appeal this judgment is sought before the *Supreme Court of Canada* (No. 28871).

Let us emphasize that divorce or nullity of marriage causes any designation of the spouse as beneficiary of the pension plan to lapse (sections 2379 and 2459 C.C.Q.). In this fashion, the privilege of exemption from seizure of the pension plan may be lost as an effect of the divorce judgment. It is therefore important to assure that a new preferred or irrevocable beneficiary is designated.

**During the distribution phase**, when the annuity is paid to the contributor, each payment is subject to seizure as it comes due. However, the annuity that is paid to a beneficiary other than the contributor under a stipulation to the effect that it is unseizable would be exempt from seizure (section 2377 C.C.Q.).

## Estate planning and tax implications following death

### On what basis will a RRSP be taxed on the date of death?

In the case of a RRSP that has not yet matured, the beneficiaries of which are neither the surviving spouse nor dependent



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children of the deceased, the deceased person will be deemed to have received, immediately before his or her death, a taxable payment equal to the amount of the fair market value of the RRSP at the date of death (section 146 (8.8) of the *Income Tax Act* ("ITA")). The issuer must file a T4RSP tax form along with a *Form 2*. Both forms must state the fair market value of the RRSP.

### Who will be liable for the deceased person's taxes?

The succession will be liable for the payment of the deceased's taxes. However, the beneficiaries who are specifically named or who benefit from a provision of a will and who will receive the entire value of the RRSP may be held jointly and severally liable to pay the taxes attributable to the RRSP, in the same proportion as the part of the RRSP that was effectively paid to each of them relative to the fair market value of the RRSP (section 160.2(1) ITA).

### Is it possible to avoid the tax impact on the transfer of a RRSP at the time of death ("rollover" at the time of death)?

When a RRSP that has not yet matured is bequeathed (by designation in the constitutive contract or by testamentary disposition) to the surviving spouse, it is possible to avoid the fiscal impact on its transmission by succession. The surviving spouse must qualify as such under the fiscal laws applicable at the time of the death of the RRSP holder, that is, the recognized surviving spouse will be the one who is the spouse of the deceased or his de facto spouse since at least a year (or less if the couple had one or more children together). A declaration of transmission will have to be completed for the RRSP to be

transferred by a tax free rollover to a RRSP in the name of the surviving spouse.

On the other hand, if the surviving spouse chooses not to receive the transfer of the RRSP by such a fiscal rollover, he or she will be taxed as having received a benefit equal to the fair market value of the RRSP at the time of death.

If the RRSP is not subject to any contrary designation or testamentary disposition, it may be also possible to defer taxes on the RRSP that has been bequeathed by purchasing an annuity for the benefit of dependent children of the deceased. Several strict requirements must be complied with in order for the annuity to be recognized as such by the fiscal authorities and to provide the expected tax benefit.

### What happens to the RRSP in the absence of a beneficiary designation or a will?

In the absence of a valid beneficiary designation or will, the RRSP will form part of the estate and will be devolved according to the intestate succession rules contained in the *Civil Code of Québec*. The successors so designated by law (named "heirs" after they have accepted the succession) may be the surviving spouse, the children of the deceased, his or her father and mother, brothers and sisters, nephews and nieces and possibly his or her uncles, aunts, great-uncles and great-aunts or cousins.

### Our recommendations

It is advisable to consult a professional specialized in these matters, such as a lawyer,

to ensure that you have all the relevant information necessary to take decisions that are consistent with your intentions.

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