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# Non-resident beneficiaries of a segregated fund contract



## Investment Insight

For a variety of reasons, segregated funds can be part of a solid investment and wealth transfer strategy. The various guarantees associated with a segregated fund contract (death, maturity, or income) can be very attractive. For others, the appeal is the ability to name a beneficiary directly on a non-registered contract for estate-planning purposes. However, many clients and advisors aren't aware of the unique

opportunity segregated funds offer to transfer wealth to a non-resident beneficiary outside of Canada.

## The value of naming a beneficiary

The value of naming a beneficiary can be significant. If you name a beneficiary, an insurance company is obligated, under the *Insurance Act* or *under the Civil code of Quebec*, to pay any death benefit proceeds to the named beneficiary on record.

Having the death benefit proceeds bypass the estate provides many advantages. It can avoid delays in settling the estate, including estate litigation. Often during this time, investments in an estate are frozen and exposed to the risks of the market (e.g., a market correction) and creditors. But if a beneficiary is named, the death benefit proceeds are usually paid within two to three weeks of receiving proper documentation while also bypassing probate<sup>1</sup> and other estate administration fees.

Probate fees will vary by province. Other estate administration, accounting, and legal fees could be another 5% or more, depending on the complexity of the estate.

Bypassing probate also preserves confidentiality, as probate is a matter of public record; payments made by insurance companies are generally a private matter.<sup>2</sup> This can be beneficial to situations where the intention is to keep your wishes undisclosed between family members.

Finally, the annuity settlement option can be used to purchase an annuity in lieu of a lump-sum death benefit that a beneficiary would otherwise receive. This strategy is particularly useful in situations where the beneficiary is a spendthrift but the intention is to avoid the expense of setting up and maintaining a formal trust.

Typically, these advantages and planning opportunities are considered in the traditional sense when transferring wealth to beneficiaries who are residents in Canada. However, if an individual has a number of children who are the intended beneficiaries, it's possible that one or more of these beneficiaries could be a non-resident of Canada. And, as such, many clients are faced with the dilemma of how to efficiently transfer wealth to beneficiaries who live abroad. When confronted with the many pitfalls an executor can face under these circumstances, it may seem

overwhelming. Segregated funds present a solution that can help remedy this problem.

## The issues

Under the Income Tax Act, non-resident beneficiaries of an estate are treated differently than resident beneficiaries of an estate. Non-resident beneficiaries present a different set of challenges to executors that carry potential for personal liability if not dealt with correctly. As well, when there are non-resident beneficiaries, decision making by executors has significant potential to create issues between the resident and non-resident beneficiaries. For example, there's a requirement for the executor to withhold non-resident tax of 25% of the gross income distributed to non-residents of Canada unless the beneficiary resides in a country where Canada has a tax treaty, in which case the withholding tax rate can be reduced.

To further complicate the issue, the deduction and remittance of withholding tax requires the executor to open a non-resident withholding tax account with the Canada Revenue Agency (CRA) and to issue an NR4 tax slip to the non-resident beneficiary reporting these amounts. Failure on the executor's part to properly execute these matters can result in the executor being held personally liable.

If certain capital assets are distributed to the non-resident beneficiary, a capital gain may be realized by the non-resident beneficiary. As such, the estate should withhold and remit 25% of the deemed proceeds to the CRA until a Certificate of Compliance (Section 116 Clearance Certificate) has been issued, as the non-resident beneficiary is subject to Canadian tax on the gain of taxable Canadian property.

If there's no inherent gain in the trust property that's distributed, there should be no tax liability. Despite this result, the CRA still takes the position that the beneficiary is required to give notice of the disposition to the CRA. Similarly, the executor can also be personally liable for tax payable by a non-resident beneficiary in respect of distributions of taxable Canadian property without having received the Section 116 Clearance Certificate.

## When things go wrong

Here's an example of how badly things can go wrong when distributing assets from an estate to a non-resident beneficiary. An executor was given faulty advice to mail a large number of bank drafts to beneficiaries residing in the U.S. As these monies weren't properly declared when entering the country, this caught the attention of border officials who seized the money, saying the money was "deemed counterfeit."<sup>3</sup> Despite the fact that one of the intended beneficiaries was in desperate need of the money because of deteriorating health and mounting medical bills, it was held by U.S. border officials for nearly a year before being released "upon further inspection" after finding the bank drafts to be legitimate.

## The opportunity

With this in mind, an opportunity exists with segregated funds—when naming a non-resident as a beneficiary of a segregated fund—to ease the amount of work and risk an executor would otherwise face. If the owner of a non-registered segregated fund contract is a Canadian resident, the tax liability on death will be included in their final Canadian tax return. For a segregated fund, the capital gain or loss will be reported to the owner on a T3 tax slip. In turn, the beneficiary, *in any country*, will receive the gross proceeds *directly*, as the death benefit bypasses the estate of the deceased and is paid to the beneficiary. There's no non-resident withholding tax withheld. However, if there's a delay from the date of death to the date the death proceeds are paid, there may be some interest paid to the beneficiary. The interest will be reported to the beneficiary on an NR4 tax slip; however, there's no requirement for non-resident withholding tax on this interest.

Additionally, when the beneficiary is a non-resident of Canada, it's still possible to accommodate the death benefit payment to the non-resident beneficiary using the annuity settlement option despite the fact that, in normal course, Manulife typically doesn't sell to non-residents directly. When the owner and annuitant of the annuity is a non-resident, the non-resident taxation rules would apply and there'd be withholding taxes on the periodic annuity payments reported on an NR4 tax slip.

When the beneficiary receives the funds, they'll need to work with their tax advisor to consider any tax implications in their country of residence—for example, an inheritance tax, or taxation on any income or growth on their inheritance.

Advisors are encouraged to help identify this potential opportunity that exists with their clients. For clients with non-resident beneficiaries, positioning a *sleeve* of their portfolio as a wealth transfer strategy can help make sure of a quick wealth transfer abroad while relieving the executor of many potential headaches while minimizing estate fees.

**1** In Quebec, the probate process and the probate fees (which are minimal) only apply to non-notarial wills. **2** In Saskatchewan, jointly held property and insurance policies with a named beneficiary are included on the application for probate but don't flow through the estate and aren't subject to probate fees. **3** It's legal to transport any amount of currency or other monetary instruments into or out of the United States. However, if you transport, attempt to transport, or cause to be transported (including by mail or other means) currency or other monetary instruments in a combined amount exceeding US\$10,000 (or its foreign equivalent) at one time, from the United States to any foreign country or into the United States from any foreign country, you must file a [FinCEN Form 105](#), "Report of International Transportation of Currency or Monetary Instruments," with U.S. Customs and Border Protection.

#### **🔒 Important disclosure** ▼

Any amount that is allocated to a segregated fund is invested at the risk of the contract holder and may increase or decrease in value.

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