TAXADVISOR

RRSP Justice

As a recent case demonstrates, getting a waiver can be a lengthy process

COURT REPORT

BY JAMIE GOLOMBEK

With the start of RRSP season just a couple of weeks away, advisors should pay close attention to the RRSP contribution limits, lest clients get reassessed by the Canada Revenue Agency on RRSP overcontributions. A case decided this past fall (Kerr v AGC, 2008 FC 1073) illustrates just such a scenario.

Lindsay Kerr was advised on September 8, 1997 via her 1996 Notice of Assessment that her RRSP contribution limit was $8,121 when in fact it was truly only $794. The error occurred because the Canada Revenue Agency incorrectly recorded Kerr's pension adjustment as "$814" instead of "$8,141."

Kerr noticed that her RRSP limit was significantly higher than in prior years despite no substantial increase in her employment income that would have justified the change. She suspected there must have been an error and spoke to co-workers and her banker who all advised her that she could simply rely on her Notice of Assessment's reporting of her available RRSP room.

In late February 1998, just prior to the 1997 contribution deadline, Kerr contributed $8,121 to her RRSP. Having previously made the allowable $2,000 lifetime overcontribution in a prior year, her true excess contribution was $7,327 (i.e., the $8,121 contributed, less the true limit of $794).

Kerr was not told the correct amount of her RRSP deduction limit for the 1997 taxation year until she received a letter from the CRA dated April 29, 2004.

That letter stated that her actual RRSP deduction limit for 1997 was $794 and provided her with Form T3012A to withdraw the excess on a tax-free basis.

Under the *Income Tax Act*, taxpayers who have an over-contribution that remains in an RRSP are liable to pay a special penalty tax of 1% per month of the "cumulative excess amount," which is basically the amount of excess contributions less the $2,000 allowance, or, in Kerr's case, $7,327.

> Advisors should pay close attention to the RRSP contribution limits – or clients could face reassessments.

If you owe this special tax, you must self-assess, calculate, report and pay the tax annually by filing Form T1-OVP, "Individual Tax Return for RRSP Excess Contributions for each year in which you have a cumulative excess amount.

If the T1-OVP forms are not filed on time, you may be liable for both penalties and interest on this 1% per month penalty tax.

As of the trial date, Kerr had been assessed over $11,000 in tax, interest and penalties relating to the overcontribution.

The CRA, however, has the discretion to waive the penalty tax "if the overcontribution occurred because of a reasonable error and if reasonable steps were taken to eliminate the excess."

Kerr requested that the tax be waived but in September 2004, the CRA denied this request. A year later, having requested an internal review of the CRA's decision to deny the request for the tax waiver, she received yet another letter from the CRA, upholding the CRA's earlier decision stating that "there does not appear to be any circumstances that would warrant the waiving of the [overcontribution] tax."

Finally, in June 2006, Kerr met with a CRA official who said that the CRA would voluntarily conduct a third administrative review even though its normal practice was to conduct only two such reviews.

In July 2007, the CRA released its final decision denying the waiver of tax, interest and penalties. The CRA stated that while "[t]he Agency accepts that it erred in reporting an incorrect contribution limit for 1997…it is our position that it was not that error that solely created or contributed to the amount owing…. Despite having questioned the amount, you chose to make the maximum contribution anyway, thus taking it outside the realm of 'reasonable error'."

Kerr took her case to the Federal Court.

Fortunately, the judge was sympathetic and called the CRA's decision not to waive the tax, interest and penalties "unreasonable." Quoting an earlier case, "the interests of justice cry out for directions putting an end to the process," the judge not only ordered the CRA to refer Kerr's request to another officer for reconsideration but also specifically ordered the CRA to conclude that the overcontribution was made as a result of reasonable error and that all tax, related interest and penalties were to be reversed. AER

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The Business of Succession

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for the protection of assets, the mitigation of taxes and the ability to control who, in the future, has a right to the estate.

"It's a classic problem: One spouse leaves everything to the other and then dies. But what if, after the death, the other spouse decides to remarry? If the surviving spouse were to die, while married to someone else, then the new spouse may be entitled to the estate and could, potentially, leave the kids with nothing. That's a serious problem."

Golombek suggests that both Phil and Liz set up testamentary trusts that give each spouse limited access to the encroachment of the capital. He suggests the Royals see a lawyer in order to set this up, as both will have to take into consideration that their spouse is, at the very least, entitled to what they would receive if there had been a divorce.

"Still, if the spouse who remarries dies, only his or her portion of the estate would pass to the new spouse, leaving the remainder to the surviving children."

The other benefit to the testamentary trust is the ability to income-split post-mortem, says Golombek. Because the testamentary trust is not taxed at the highest rates, as an *inter vivos* trust would be taxed, but at graduated rates, this allows for the post-mortem income-splitting by having income taxed inside the trust post-death instead of in the hands of a high-income beneficiary.

"The Royals could set up four testamentary trusts and could potentially save over $12,000 in taxes annually, per trust," says Golombek. "Plus Phil and Liz could limit the amount the kids have access to, thereby ensuring that their kids do not spend all the money at once." Even if some of the children, like Eddie, can be trusted to be responsible with the inheritance, Golombek suggests the Royals still use a trust. "The potential to reduce the tax on the future income from the inheritance through post-mortem income-splitting is huge!"

ESTATE PLANNING: LEGACY GENERATIONS

While Liz and Phil are under no obligation to leave their estate to non-minor children, their intentions need to be clear and should be expressed in their wills, says Swanson.

This issue, however, prompts a more fundamental issue Phil and Liz will need to address: Their desire to "control the distribution" of their estate to only "natural heirs."

Both Swanson and Korvan believe potential problems will arise if this desire is pursued.

"The Royals could include provisions for DNA testing or they could specifically spell out in the will instructions for the executor to divide the estate only among natural heirs, but this puts the executor in the hot seat," and leaves the will open to being contested, says Swanson. "Hal has been treated like a grandson so to stop treating him as such would prompt problems. My advice is that Hal should be included as a beneficiary regardless of lineage."

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If the Royals refused to acknowledge Hal as a grandson, Swanson suggests that the couple "not use words to legally exclude children born out of wedlock, [but rather] use words to direct" the inheritance.

"I would not encourage people to state reasons, in their will, for their intentions," says Swanson, as the burden of proof then is on the estate to prove the reasons are accurate. "Instead, I would encourage them to acknowledge that they are not leaving money to a particular person without stating a reason, particularly since the will is a public document." If the Royals insisted that their potential heir should know the reason for the exclusion, Swanson suggests asking Phil and Liz to compose a private letter to the heir. "Put the reasons in a separate document;" one not considered a public document and, thus, need not be submitted into court.

Yet, one grandchild that does appear to cause Liz great concern is Mary – Annie's mentally disabled non-minor child.

Liz, in particular, is very concerned that Mary is taken care of even after she and her husband are gone. In her efforts to gain some clarity on what to do for Mary, Liz is told that she may be able to roll her RRSP into the recently created registered disability savings plan (RDSP), which will solely benefit Mary. As of December 2008, approximately 10 financial institutions will launch the RDSP. Another means of ensuring that Mary receives the benefit of her inheritance, without incurring clawbacks from government assistance, would be to use a Henson or discretionary trust, either completed on an *inter vivos* basis or included in the wills.

Liz and Phil also need to consider that any money left to a minor grandchild residing in the U.S. will require a trustee to oversee the estate. "It is unlikely that Andy can be the trustee because he lives in a different state than his children," explains Korvan. "That requires Liz and Phil to find another trustee or a professional fiduciary if they do not want Andy's ex-wife, and mother to the children, to control the portion of the estate left to the grandkids, which could include shares of the business." AER

Next month, in **PART 3** of AER's coverage of the IAFP Symposium, we finish off the Royals' case study by mentioning all remaining considerations needed for a complete financial plan. We include options, ideas and solutions submitted by readers regarding the case study.

If you are interested in commenting on any of the suggestions provided, or offering an alternative solution to the Royals' financial plan dilemma, please email: editor@advisorsedgereport.com.