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COMMENT

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DISPOSITION OF A LIFE INSURANCE POLICY

There are many reasons why the owner of a life insurance policy might want to transfer ownership of the contract. As time evolves, the initial ownership of the policy may no longer make sense. The need for a change in ownership could be triggered by an event such as a corporate reorganization, a change in personal circumstances such as a marriage or divorce or, perhaps, the availability of a more efficient ownership structure for funding the life insurance premiums.

In looking at the transfer of a life insurance policy, it is important to understand whether it will be viewed as a disposition of the policy because of the resulting tax consequences. The term "disposition" is defined within the Income Tax Act and is both inclusive and exclusive in nature. A disposition includes a surrender of the policy, taking a policy loan, maturity of the contract or a change by operation of law. The definition goes further and defines activities that are not considered a disposition. A disposition does not include the collateral assignment of a policy, a lapse if the policy is reinstated within 60 days of the end of the year, a payment of a disability benefit, an annuity payment, or a death benefit payment from an exempt life insurance policy.

Where a disposition occurs, a gain on the policy may be triggered. The amount to be included in income is generally equal to the proceeds of the disposition of the interest in the policy, minus the policyholder's adjusted cost basis of that interest. This is not a capital gain, but is fully taxed like interest income. The wording of the provision contemplates that a policyholder could dispose of only a portion of a policy (i.e., an 'interest' in the contract). This could arise, for example, because of joint ownership or a split dollar arrangement, or more commonly, because of a partial cash withdrawal from a contract. It should be noted that a loss cannot occur on the disposition of a policy because of the wording of the income tax provision.

When it comes to the tax consequences of the disposition, the general rule is subject to a number of exceptions. For example, some exceptions allow a tax-deferred rollover while others use a deeming rule to establish the proceeds of the disposition.

The rollover and deeming rules apply depending on the relationship between the transferor (i.e., the current owner) and the transferee (i.e., the new owner). When a rollover of the policy is permitted, the policy transfer takes place at its adjusted cost basis, resulting in no policy gain and therefore no immediate tax consequences. When the deeming rule applies, the proceeds can be deemed to be the policy's cash surrender value, which would trigger a policy gain if that amount is greater than the policy's adjusted cost basis.

Spouses can transfer a life insurance policy between them on a rollover basis during their lifetime, or upon death if both spouses are resident of Canada at the time of the transfer. The rollover between spouses is automatic unless the transferor elects out of the rollover. The transaction will be deemed to have occurred at the transferor's adjusted cost basis, and the transferee will be deemed to have paid the same amount.

A parent can transfer a policy on his or her child's life to a child, on a rollover basis. The provision is broadly worded such that:

a. the life insured under the policy must be a child of the transferor; and,

b. the transferee must be a child of the transferor.

The child whose life is insured under the policy does not have to be the transferee (i.e., the same in (a) and (b)). Additionally, by definition the "child" can include a grandchild. This means that a grandfather could insure his son and transfer the policy to his adult grandchild. In order to complete a transfer on death, the parent would have to name the child as the contingent owner under the contract; otherwise, the title of the policy would first transfer to the parent's estate, and there is no rollover provision from the parent to the parent's estate nor from the parent's estate to the child. If the child is a minor, consideration should be given to transferring the policy to the surviving spouse, who could in turn transfer the policy to the child at the appropriate time.

Where the transfer is between non-arm's length individuals (other than a transfer to a spouse or child), a special deeming rule will apply to deem the transfer price to be the cash surrender value of the policy irrespective of the actual transfer price agreed upon

between the parties. It should be noted that when a company is transferring a policy to its shareholder, the transaction should be completed at fair market value; otherwise, the shareholder benefit rule will apply a taxable benefit equal to the excess of the fair market value over the actual transaction price. Note that determining fair market value can be complex since such a determination must take into account numerous factors, including the insured's state of health.

A life insurance policy does not fall within the rollover rules of section 85 of the Income Tax Act, which allow an individual to roll over certain capital and other properties to a corporation. However, a life insurance policy is eligible for rollover treatment during the course of a corporate wind-up or amalgamation.

There are many reasons why the ownership of an insurance policy might be changed, and it is important to know the income tax implications before any such transfer occurs. While this article provides a brief summary of some of those rules, the ITA provisions can be complex and one may require professional guidance in order to be prepared for the financial consequences.

I/R 7401.043

ADJUSTED COST BASIS

The adjusted cost basis ("ACB") of a life insurance policy is important when a policyholder wants to dispose of all or a portion of his or her policy, or when a corporation receives life insurance proceeds and needs to calculate the resulting credit to its capital dividend account.

The definition of ACB in the Income Tax Act ("ITA") is complex, containing eight factors that increase the ACB and five factors that decrease the ACB. Each component is calculated separately on an accumulating basis, and the ACB is calculated by adding together the positive components and deducting the negative components. The ACB of a policy can be negative; however, where that is the case, a value of "nil" or zero is used in any policyholder tax calculation.

The two main items that affect the ACB calculation are the:

- "premiums" paid, which increases ACB; and,
- "net cost of pure insurance", which decreases ACB.

The term "net cost of pure insurance" sounds technical in nature, and one might expect that the ITA would contain a detailed definition of the term (indeed it does, but that is beyond the scope of this article). In general, the term "net cost of pure insurance" represents an annual mortality cost that increases each year as the life insured gets older.

The meaning of "premium", on the other hand, may seem fairly clear at first glance; however, that is a false perception. For example, the ITA definition of premium excludes any amount paid with respect to an accidental death benefit, a disability benefit, or an additional amount for substandard risk under the policy in question.

This definition of premium was the subject of a recent case before the Tax Court of Canada. The facts of the case are as follows:

- A policy was issued to Karl Kratochwil on January 14, 1987.
- In August 1993, the policy obligations were assumed by Standard Life.
- The policy was surrendered on August 2, 2007, for its cash surrender value of $150,365.75.
- The premium for the basic insurance coverage, without any additional risk element, was $421.75 per month, or $75,915 over the life of the policy.
- The premium associated with insurance coverage for risks beyond the basic insurance coverage was $262.90 per month, or $47,322 over the life of the policy.
- In addition, there was an additional risk charge of $172.15 per month for 24 months, or $4,132 in total.

In filing his personal tax return in 2007, Karl claimed $22,997 as the policy gain with respect to the surrender of the policy. Karl arrived at the gain by subtracting the sum of all premiums paid under his policy from the cash surrender amount received. Karl filed his tax return prior to having received a T5 slip from Standard Life. That T5, however, showed a policy gain of $112,094 with respect to the disposition of the life insurance policy.

The Canada Revenue Agency (CRA) reassessed Karl, adding $89,094 to his 2007 income.

Karl objected to the CRA's reassessment and appealed to the Tax Court of Canada. The Tax Court judge quickly dispatched the case, noting in the judgment; "I have reviewed the Minister's calculations … and have determined that they are accurate."

The court case does not specifically address the reason behind Karl's appeal of the CRA's assessment; however, Karl obviously disagreed with the assessment and was likely perplexed as to why the full amount of premium he had paid from after-tax dollars was not returned to him tax-free.

The communication gap in this case lies in two facts. First, the ITA defines the term premium, and a plain English meaning of the word does not suffice. Secondly, the cost of insurance (or NCPI) reduces the ACB of the policy. The result is that a straight-forward calculation that an individual can easily replicate is not always possible; rather, the insurance carrier needs to separate the premium relative to the type of risk associated with the insurance policy, and to reduce the remaining premium by the amount needed to cover the insurance risk, in order to track the policy's ACB appropriately.

The adjusted cost basis of an insurance policy is an important figure, but it is a calculation that is generally impossible for the policyholder to perform on his or her own. Whenever a transaction involving the policy takes place, it is important for the policyholder to understand the income tax consequences. Information on the policy's ACB should be obtained from the insurer before any transactions are undertaken.

I/R 7401.043

LIVING VALUE IN LIFE INSURANCE

The primary value of a life insurance policy is in the benefit that arises upon death. The death benefit creates capital for the insured's beneficiary, or helps pay taxes and expenses that arise upon death. In addition, value can be generated during the insured's life time. Using a life insurance policy to accumulate funds for future use such as retirement income has been a long-standing financial planning strategy. As financial products have evolved, planning with a life insurance policy has transitioned to a broader array of ideas with increased complexity.

While there is no income tax relief on deposits into a life insurance policy, generally the investment earnings on the cash value that accumulates within the policy do not attract annual taxation. When the policyholder wants to access the cash that has accumulated, a partial withdrawal may be possible. This may trigger a policy gain if the amount withdrawn (proceeds of the disposition) is greater than the adjusted cost basis allocated to the withdrawal.

Accessing cash within a policy has been facilitated through a strategy that utilizes a collateral loan to access the build-up of cash value. The proceeds of the loan are acquired without triggering immediate tax consequences, while the loan is secured by the cash value in the policy. Upon the death of the life insured, the loan is repaid with the proceeds of the policy. In this way, funds have accumulated on a tax-sheltered basis, and have been accessed tax-free, and any residual death benefit is paid to the beneficiary on a tax-free basis. Interest paid on such a loan is not deductible for income tax purposes.

A further refinement of this strategy involves the accumulation of surplus corporate funds inside a corporate-owned life insurance policy. An individual may decide to accumulate funds in his or her private company because the corporation pays tax at a lower rate, thus making after-tax life insurance premiums cheaper to the corporation. For example, $100,000 of income earned personally generally results in an immediate tax cost of about $45,000, while this same amount of active business income at a corporate level will trigger a tax-cost of about $15,000 to $18,000, depending on the province of residence. The lower cost of corporate funds thus makes this strategy attractive. When funds have accumulated inside the corporate-owned life insurance policy, the shareholder could, eventually upon retirement, cause the company to borrow against the policy and use the funds to pay out a dividend to the shareholder.

Alternatively, the shareholder may decide to borrow directly from the bank and ask the company to secure the loan by collaterally assigning the corporate-owned life insurance policy. This arrangement has to be carefully constructed and certain protocols observed in order to avoid any unexpected income tax implications. The following points should be considered:

- CRA has indicated that it will assess a taxable benefit equal to the amount of the entire loan if the corporation is guaranteeing a loan that the shareholder is unable to repay.
- Another taxable benefit will arise equal to the value of the guarantee being offered by the company by collaterally assigning the corporate-owned life insurance as security for the loan to the shareholder.
- Another taxable benefit may arise if the company is called upon to repay the loan under the terms of the guarantee for the shareholder.
- Finally, a taxable benefit may arise upon the death of the life insured if the lending institution claims against the payment of life insurance proceeds before the payment is made to the company.

The shareholder should pay a fee to the company for guaranteeing his or her loan. The value of the guarantee could be determined as the difference between the bank loan rates with and without the guarantee. Alternatively, the value of the guarantee could be determined by the open market and the interest rate a financial institution would charge the shareholder under similar circumstances.

The guarantee offered by the company to the shareholder for the loan should be documented in an agreement. The agreement should include specifics as to the fee to be charged and the frequency of its payment. As well, the agreement should deal with the results if the company were called upon to pay towards the shareholder's loan. In that case, the guarantee agreement should make the company the creditor, which avoids an immediate shareholder benefit. It should be noted, however, that the shareholder has to repay the loan before the second following year-end of the company; otherwise, the entire amount owing becomes a taxable benefit.

Planning with life insurance can offer interesting opportunities. However, some of these alternative plans can be very complex and may attract the attention of the Canada Revenue Agency if they are not set up and carefully maintained over the life of the structure. It is crucial to demonstrate that the alternative chosen is the best given the policyholder's specific circumstances.

I/R 6401.00, 4400.00

NANNY ADVANTAGES

A nanny can be an important part of a family's life, providing reliable care for the children and helping keep up with the many other facets of a busy life. Employing a nanny can also provide some tax relief depending on the situation.

A tax deduction is available for child care expenses. The deduction is the least of three amounts:

1. the actual amount spent on child care;
2. $7,000 for each child age six or less, plus $4,000 per child for those between ages seven and sixteen at some point throughout the year, plus $10,000 for a child who is eligible for the disability tax credit regardless of that child's age; and
3. two-thirds of the lower-income spouse's earned income.

The objective of the deduction is to provide some income tax relief to working parents who incur eligible child care expenses to allow them to earn an income.

The type of expenses that qualify as child care expenses include items such as: salaries for caregivers (including the employer's portion of CPP, EI and WCB); advertising/placement fees to locate a nanny; daycare centres; a portion of the fee paid to educational institutions for child care expenses; day camps where the primary goal is care for children; or boarding schools/camps where lodging is involved. There are some limitations in terms of the amount of the expense that is eligible, particularly with respect to boarding schools and camps.

Non-qualifying expenses include the education component of institutional fees, medical/hospital care, clothing or transportation.

It is interesting to note that it is the total of the actual expenses incurred that is used in the formula, compared against a single number that is based cumulatively on the number and age of the children. This is important as sometimes care for one of the children costs more depending on needs and circumstances, or collectively care for the children as a group costs a certain amount which cannot be allocated reasonably among them. This would mean that a salary of $20,000 paid to a nanny to care for twin four-year-olds and an eight-year-old would not have to be allocated to the children individually, provided the total is within the formula amount.

There is a limitation with respect to who provides the child care. Expenses paid to the child's mother or father, a spouse, or common-law partner are not eligible for the deduction. As well, expenses paid to a related person who is under age 18 are not deductible. The term related person would typically include an older child of the parent or common-law partner. However, a niece or nephew is not considered to be related, so child care amounts paid in this case could be qualified expenditures. Amounts paid to grandparents would also be eligible.

The documentation supporting the claim does not have to be filed with the individual's tax return but should be retained in case the Canada Revenue Agency requests a copy. Organizations that provide child care services will generally issue a receipt that details the child's name and the amount of expenses. When individuals provide child care services, the receipt must also include the social insurance number of the individual.

The third criterion in the deduction formula generally limits the deduction to two-thirds of the lower-earning spouse's "earned income". This term is specifically defined within the Income Tax Act for the purposes of the child care deduction and incorporates income amounts that reflect the original purpose of this deduction, such as: employment income; tips; net self-employment income; the taxable portion of scholarships; CPP/QPP disability benefits; plus a few other items that would be taxable to the individual. It is important to note that the definition differs from "earned income" for RRSP purposes. Where the lower-income parent is attending school, is unable to care for the children because of a physical or mental infirmity, or is in prison, the higher-income parent may be eligible to claim the deduction.

Child care expenses can represent a large portion of a family's monthly expenditures, and the tax rules provide some relief where both parents are working or under other limited circumstances.

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