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COMMENT

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Edition 297 – May / June 2016

LIFE INSURANCE AND NEW CDA CALCULATIONS

The capital dividend account (CDA) is an important element of Canada's income tax system that allows a Canadian-controlled private corporation (CCPC) to pass through certain non-taxable receipts to its Canadian-resident shareholders. As a notional tax account, the CDA helps ensure a certain level of tax integration, providing similar effective tax rates whether the receipt flows directly on a personal level or indirectly through a corporation.

Generally speaking, there are four non-taxable items that receive capital dividend treatment: the non-taxable portion of net capital gains; the non-taxable portion of the gain realized on the disposition of eligible capital property; the amount of life insurance proceeds in excess of the company's adjusted cost basis (ACB) in the contract; and, any capital dividends received from a subsidiary company. The balance in the capital dividend account is reduced by any capital dividends paid out to the company's shareholders.

The 2016 Federal Budget delivered on March 22, 2016, proposes two significant changes with respect to the life insurance element of the capital dividend account.

ACB IMPACT ON CREDIT TO CDA

Pre-Budget: The receipt of life insurance proceeds by a corporation creates a credit to the CDA. In simple terms, the credit was calculated as the life insurance proceeds in excess of the owner's ACB in the policy, with the credit occurring at the time when the proceeds are received. Assume, for example, Holdco owns a life insurance policy and names its subsidiary, Opco, as the beneficiary of the policy. The insurance policy's ACB belongs to Holdco as owner of the policy; Opco, as beneficiary, does not have an ACB in that policy. Under this approach, Opco could receive a CDA credit equal to the full amount of the insurance proceeds without regard to the policy's ACB.

Post-Budget: Under the new rules, the life insurance policy's ACB will be subtracted from the life insurance proceeds when calculating the credit to the CDA regardless of the actual owner of the life insurance policy. This means that when the holding company as owner of the life insurance policy names a subsidiary company as the beneficiary, the holding company's ACB in the policy will be used to calculate the beneficiary's credit to its capital dividend account. This new rule will be effective for deaths occurring after budget day.

NON-ARM'S LENGTH TRANSFERS

The budget introduced a new measure that impacts the CDA in situations where a corporation became the owner of a life insurance policy because of a transfer from a non-arm's length party and subsection 148(7) was used to deem the proceeds of disposition to be the policy's cash surrender value. If this situation has occurred at any time prior to the receipt of the life insurance proceeds, then the beneficiary's credit to its capital dividend account will be reduced by the fair market value of proceeds received in excess of the cash surrender value when the transfer occurred.

Of particular importance is the fact that this change applies to pre-budget policy transfers. In simple terms, any time a non-arm's length taxpayer has derived the benefit of the pre-budget rules that allowed for the tax-free removal of corporate surplus, the parties will now be subject to a readjustment that had not been anticipated.

Let's look at an example of a non-arm's length transfer. Assume the policy transfer occurred prior to 2016 budget day and the shareholder's death occurs subsequent to budget day.

Katy, the sole shareholder of company B (Bco), personally owned a life insurance policy on her own life, which she transferred to Bco several years ago. At the time of transfer, the policy had a death benefit of $1,000,000, cash surrender value of $70,000, adjusted cost basis of $50,000 and fair market value (as determined by an actuary and supported with a written report) of $400,000. Bco paid Katy $400,000 for the policy.

If the transfer occurred before March 22, 2016 (budget day), Katy's proceeds of disposition were deemed to be the policy's cash surrender value ($70,000) regardless of the fact that Bco paid her $400,000 for the policy. At the time of transfer, Katy would have realized a policy gain of $20,000 (deemed proceeds of disposition in excess of her ACB in the policy). Bco would have a starting adjusted cost basis of $70,000, which represents its deemed cost of acquisition.

Assume Katy passes away after budget day and there has been no change to the policy's ACB since the purchase by Bco. Bco collects the life insurance proceeds as owner and beneficiary of the life insurance policy and is entitled to a credit in its capital dividend account. The CDA credit begins with the amount of the life insurance proceeds in excess of the adjusted cost basis of the policy, which is then reduced by the fair market value of the consideration paid for the policy in excess of the cash surrender value of the policy. The result is that Bco is entitled to a $600,000 credit to its capital dividend account as calculated using the new rules.

Calculation of Bco's CDA Credit	
Proceeds of life insurance	$1,000,000
Less: ACB of the policy (Bco's starting ACB would be the deemed proceeds of disposition to Katy)	$70,000
Less: fair market value of the consideration received by Katy in excess of the deemed proceeds received by Katy $400,000 - $70,000	$330,000
Bco's credit to its CDA	$600,000

NON-ARM'S LENGTH TRANSFERS

A third change proposed in the 2016 Federal Budget, related to life insurance policies, involves the full replacement of subsection 148(7), the provision that deals with non-arm's length transfers of life insurance policies. The new provision will deem the proceeds of disposition to be the cash surrender value of the policy plus the fair market value of the consideration paid in excess of the policy's cash surrender value. The purpose of this change is to eliminate the ability to remove surplus on a tax-free basis using the life insurance rules.

It will be important for companies to track the information necessary to calculate any credit to their capital dividend account with respect to life insurance policies. This means locating and retaining all documentation with respect to the transfer of any life insurance policy between non-arm's length parties. Life insurance companies may be able to assist in determining the chain of ownership from the date of issue to the date of death, but they may not have information about the fair market value of consideration paid in respect of a given transfer.

Tax rules are always subject to change and it is important to determine if the change impacts a client and what sort of documentation will be required to support the new filing obligations.

CHANGING CIRCUMSTANCES CAN CREATE UNEXPECTED CONSEQUENCES

There are times when a plan has been put in place, but a change in circumstances creates unexpected consequences as illustrated in the recent case of *Dagg v. Cameron* Estate.

The case begins with a couple, Steven and Anastasia, who were married in 2003. In January 2012 the couple separated, but remained legally married. In 2010, while married, Steven purchased a life insurance policy from Canada Life with a $1 million face value. At the time of separation, Anastasia was named as beneficiary of the policy. As part of a series of ongoing court proceedings between Stephen and Anastasia, which commenced in September 2012, Steven was subject to a consent order that included child and spousal support provisions and required that he maintain Anastasia as the irrevocable beneficiary of the life insurance policy.

Immediately following his separation from Anastasia, Steven re-established a relationship with Evangeline, whom he knew prior to his marriage. In July 2012, Steven moved to British Columbia and frequently travelled to Bellingham, Washington, where Evangeline lived. Evangeline became pregnant in April 2013 and while the couple intended to marry, their plans were delayed because of prolonged divorce proceedings between Steven and Anastasia.

In November 2013 Steve was hospitalized, and shortly thereafter executed a new will together with a change to the beneficiary designation on his life insurance policy. He changed the beneficiary from Anastasia, as the sole beneficiary, to Anastasia (10 percent), Evangeline (53.6 percent) and his two living children (17 and 19.4 percent). Anastasia became aware of the beneficiary change and immediately obtained a court order requiring Canada Life to restore the previous designation listing her as sole beneficiary.

Steven, age 48, passed away on November 23, 2013, with the insurance policy forming the bulk of his estate.

Evangeline filed a dependant's support claim, with the Ontario Superior Court, on behalf of herself and her newly born child (she was pregnant when Steven passed away). She sought to have the proceeds of life insurance form part of Steven's estate so they would therefore be available to satisfy a dependant's relief claim under the Succession Law Reform Act (Ontario). The trial judge agreed and ruled that the proceeds of the life insurance policy would form part Steven's estate and would not be paid to the named beneficiary.

Anastasia appealed the trial judge's ruling, asking the Divisional Court to award all of the life insurance proceeds to her as set out in the consent order. Anastasia's position was that the consent order should be interpreted as a bare trust and Steven did not have the authority to change the beneficiary.

The Divisional Court agreed with the trial judge confirming that Steven remained the owner of the life insurance policy irrespective of the Family Court order requiring Anastasia remain as the named beneficiary. Of significance was the Court's finding that Steven remained in control of the policy. They found no evidence of any intention to change legal or beneficial ownership of the policy. The court noted that under "Ontario succession law, 'any amount payable under a policy of insurance effected on the life of the deceased, and owned by him or her,' is available for satisfaction of dependent support claims."

The court noted that if Anastasia and Steven had wanted the insurance proceeds to be paid to Anastasia under all circumstances, they should have stated this explicitly. The couple could have referenced the policy proceeds as "security" for the support payments, moved the policy into Anastasia's ownership or into joint ownership. Without some evidence of their intentions the court is obligated to ensure that dependents are supported.

While Anastasia attempted to claim the position of a creditor of the estate because of the Family Law Act support order and irrevocable beneficiary designation, the Insurance Act "provides that where a beneficiary is designated, the insurance money, from the date of death, is not subject to the claims of the creditors of the insured." As such, the court concluded that "Anastasia's interest in the insurance proceeds was not that of a creditor, but rather as a dependant, along with her children, and Evangeline and James."

The Divisional Court also concluded that Evangeline and her child, conceived with Steven and born after his death, were dependant on Steven. They observed that Steven's attempt to provide adequately for Evangeline and her child was circumvented by the court order requiring Canada Life to restore the original designation. The Divisional Court confirmed Evangeline and her child's entitlement for support from Steven's estate.

Of significance is the fact that there are situations where an individual could be viewed as having two spouses for support purposes, creating significant financial obligations. Arrangements of this nature require careful attention to both financial and moral responsibilities when undertaking estate plans. If a life insurance policy is intended to represent future support for one particular spouse or group of dependants, it may be wise to ensure ownership of the policy remains with the intended beneficiary or in joint title.

Plans should reflect the objectives of the client, but more importantly the plans need to be well documented so that the intentions of the parties are well known and alternative interpretations will be limited.

CHILDREN AND YOUR ESTATE PLAN

Estate planning in respect of children is not child's play; for many, it is one of the most important elements of their estate plan.

As a parent of minor-aged children, capturing the full breadth of financial needs and providing appropriate resources can be a challenging exercise. A parent's estate plan should consider all of the following income or cash flow needs that may arise in respect of a minor child:

- The daily requirements of life such as food, housing, clothing, sports, travel, and all of the activities that fill a child's growing-up years.

- Sufficient funds to complete a reasonable education including tuition for private school, if desired, and post-secondary education. Added into the mix are books and supplies, room and board while away, tutors and supplemental sessions, and resources to replace the role a parent might otherwise play in the child's education cycle.

Beyond the childhood years, parents with sufficient estate resources may consider:

- Providing financial resources for the child's first home or a contribution toward a reasonable down payment that might allow the child's earnings to support the resulting mortgage.
- A financial contribution toward wedding festivities or other memorable contributions to a child's personal milestones.
- Miscellaneous gifts that might have been otherwise provided, such as a post-graduation trip aboard, first car, etc.

Once the full breadth of financial needs has been captured, an analysis of the various structures that could be utilized to hold the appropriate funds will help to shape the estate plan. The first option that most couples often consider is leaving sufficient funds for the surviving parent to meet the ongoing financial needs of the children. In these situations, however, it is easy to miss the cost of the smaller, less obvious items which can leave a single parent without sufficient resources that might otherwise have been available if a death of the co-parent had not occurred.

If the surviving spouse is going to assume financial responsibility for the children, the testator typically leaves his or her financial assets and life insurance policies to the surviving spouse with the expectation the spouse will provide for the child. This makes sense when the surviving spouse is also the parent of the children so has a similar interest in the children as that of the testator. However, there could be situations where this may be inappropriate and other structures should be considered for some or all of the funds planned for the child. The surviving spouse may be a spend thrift or may not be the child's parent. For example, a second marriage can often involve children from the spouses' prior marriage (or relationship) and non-traditional family responsibilities can create unusual financial needs.

Sometimes the child may be older and mature enough to accept and manage an outright gift or support payment from the parent's estate. There are times, however, when some parents might hesitate to leave outright gifts because their frame of reference is based on today's world where they can adjust or redirect support if they observe the child making what they feel are inappropriate or bad decisions. Each situation is unique and, as a child ages, a parent's confidence in their financial savvy will evolve.

Another structure that should be considered is a testamentary trust arising upon the parent's passing, which is funded with resources from the deceased's estate or from a life insurance policy. The testator is the settlor of the trust and chooses appropriate trustees. The design of the trust creates comfort for the parent because the trust provisions can offer directions to the trustees. For example, the provisions can set out how the funds are to be invested, how and when income and capital is to be distributed, directions as to what happens if a child does not survive to a distribution date and details about the eventual winding-up of the trust, if desired.

A parent is not limited to one approach but can use various structures for different portions of the estate. Customization is easily achieved to ensure the parent's objectives are reflected in the overall estate plan. The planner's role is to ensure that objectives are actionable using appropriate structures.

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Edition 297 - May / June 2016

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Publication Agreement # 40069004

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