CLU 255

Advanced Concepts in Tax & Law for Personal Planning

CLU Program

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Course Objectives

This course focuses on wealth transfer and estate planning strategies for individuals and families. Descriptions of law and tax structures lead to discussions on applicable financial planning approaches for individuals and families including:

- The use of life insurance and living benefits to manage personal risks and wealth preservation;
- The creation of trusts and other instruments to ensure the orderly transfer of individual wealth;
- The examination of the special tax reporting obligations facing individuals who enter or leave Canada;
- The examination of client objectives and responsibilities at death including tax and legal obligations and how they can be reconciled to the wealth transfer and estate planning intentions of the testator.

Course Outline

Candidates have 120 days from the date of registration to complete this course. The course is divided into four separate modules.

Module	Topics Covered
Module 1: The Canadian Legal System & Income Tax Administration	The Canadian Legal System Contract Law Income Tax Administration
Module 2: Taxation of Life Insurance & Living Benefits	Life Insurance Annuities Segregated and Mutual Funds Living Benefit Products
Module 3: Income Splitting & Taxation of Trusts and Beneficiaries	Income Splitting Trusts
Module 4: Tax Planning for Charitable Giving, Death, and Retirement	Death of a Taxpayer Charities Taxation of Retirement Plans International

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Module 1: The Canadian Legal System & Income Tax Administration

Learning Objectives

Upon completion of this module, you should be able to:

- Discuss the Canadian legal system as it applies to the development and application of the Canadian income tax regime, including the development of tax policy, legislation and the Canadian court system;
- Understand and explain advanced elements of a business contract including its formation, ongoing accountabilities, and consequences of a breach;
- Describe the administration of the Canadian income tax system with an emphasis on the assessment process, available recourse, and initiatives to enhance compliance.

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The Canadian Legal System

Introduction

The majority of Canada's laws are put into place through:

- The legislature where parliament enacts laws;
- Regulations that relate to the laws and which are enacted through the governing body's cabinet; and,
- Decisions of the court also referred to as common law.

The concept of **common law** dates back many centuries to European and English law. In general terms, common law is a system in which decisions made by the courts become rules that are known as **precedents**. A precedent is not encoded into any act and it can change through time. The term **stare decisis** is a Latin term that means to abide by an earlier decision. Decisions of the courts create what is referred to as a common law system.

Québec is an exception because it operates under a comprehensive set of rules that are referred to as a **civil law system**. In simple terms, the rules are designed as broad principles and are codified in law. The courts look to the Code when disputes arise.

Throughout this course, the material refers to common law jurisdictions unless otherwise noted.

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Creating Legislation

In Canada, both the federal and provincial governments have law-making authority for their respective areas of jurisdiction. When laws are created through parliament, they may be referred to as **statutes**, **legislation**, or **acts**. A new statute becomes the overarching authority on previous common law or case decisions in respect of the same subject.

The Canadian courts interpret laws, and from these decisions, precedents arise and can be changed. Decisions that create precedents are used by future courts when interpreting and applying the law.

The federal government has authority to deal with laws related to subjects that affect Canada as a whole, including items such as money, patents, postal services, national defence, interprovincial trade, and federal income taxation. Provincial authorities deal with subjects of a provincial nature such as civil rights, property, education, and hospitals.

Municipal government represents an additional layer of government where the provinces cede authority to the municipalities, giving them the right to enact laws related to local matters such as parking, zoning, and business regulations.

Canada's **Constitution** is the overarching law with which all other laws must abide in order to be valid.

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Canadian Tax System

Income Taxation

Canada first imposed federal income tax in 1917 through legislation outlined in the *Income Tax War Act*. Originally intended as a temporary measure to assist with financing World War I, the legislation evolved through time. The ITA, enacted in 1948, combined the temporary measure with new legislation to create a permanent and ongoing act – what was intended as a temporary measure became permanent. The general principle of income tax is to assist with funding public expenditures that are important to Canadian social and economic policies.

Tax Reform

Over the course of time, there has been ongoing discussion about tax reform, with the first major initiative being the Royal Commission on Taxation. It became known as the Carter Commission because Kenneth Carter chaired this group. Mixed reviews of the 1966 recommendations arising out of the Carter Commission led to vigorous debate about the extensive array of recommendations. Many aspects of the Carter Commission are often cited in policy discussion today, over 60 years later.

The federal government established another group leading to a subsequent report- Proposals for Tax Reform (White Paper), published in 1969. Substantial legislative changes arose as a result of this document, including the introduction of capital gains tax. From this point onward, there has been a regular flow of federal budgets presenting changes to Canada's income tax system.

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Goods & Services Tax (GST)

On January 1, 1991, **Goods & Services Tax (GST)** became effective and has been an ongoing tax throughout Canada. GST is a **value-added tax (VAT)** that applies to the supply of most property and services throughout Canada. In simple terms, it was a replacement for another value-added tax, Manufacturers' Sales Tax, levied at the manufacturing level and was non-transparent to the consumer. Five provinces [Ontario, Newfoundland and Labrador, New Brunswick, Nova Scotia, and Prince Edward Island] have combined their provincial sales tax with the Goods and Services Tax to create a single tax now referred to as a **Harmonized Sales Tax (HST)**. The important issue to understand is that GST and HST are not an income tax and are administered through a separate federal act.

Projections on Personal Income Tax Revenues

The 2018-19 federal forecast estimated personal income tax would generate about $161.4 billion, growing to approximately $190 billion in four years' time. Corporate income tax represents a much lower percentage with the 2018-19 federal forecast amount expected to be in the $47.3 billion range, growing to about $52 billion over the next four years. In 2018–2019 projections, personal and corporate income taxes accounted for 65 percent of every dollar raised by the federal government, while Goods and Services Taxes contributed 12 percent.

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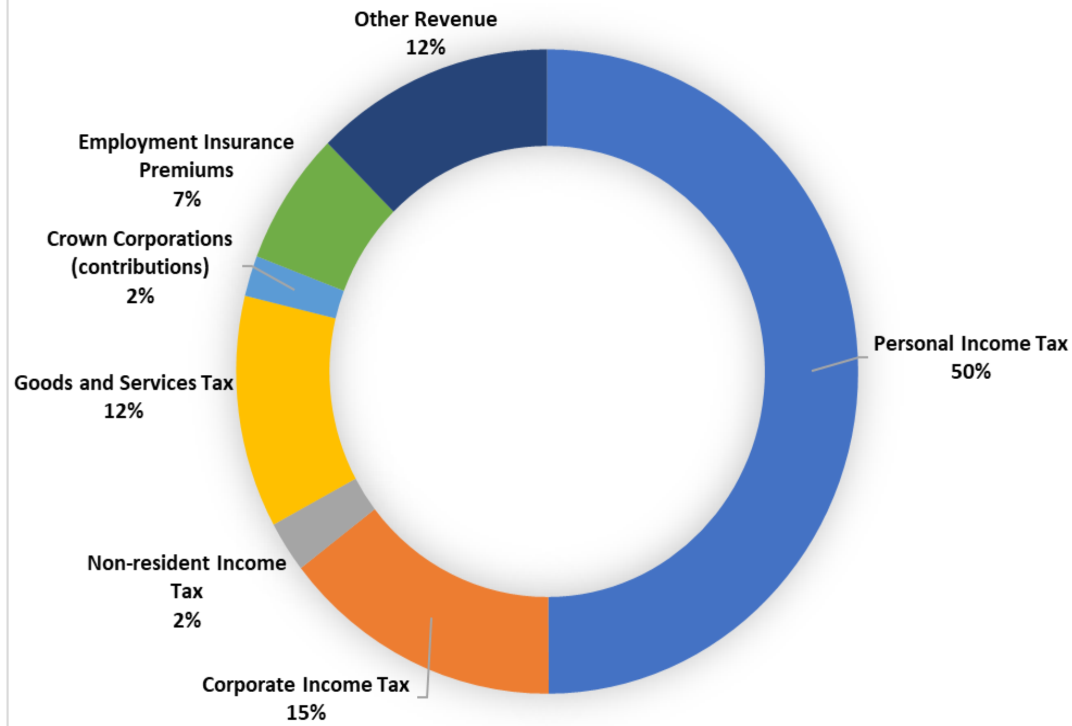

Source: Annual Financial Report of the Government of Canada, Fiscal Year 2018-2019

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Development of Legislation

The **Department of Finance (DOF)** collaborates with other government departments to gather input, as it is responsible for developing policies and recommendations on a wide variety of economic issues. The DOF makes recommendations to the Minister of Finance and prepares federal budgets along with economic and fiscal forecasts. It also develops tax policy and supporting legislation.

The **Canada Revenue Agency (CRA)** is accountable for administering Canada's taxation system. This involves the assessment and collection of income taxes, often referred to as enforcement of the ITA. The administration of some social benefits also falls within the scope of the CRA's responsibilities. The **Minister of National Revenue** is responsible for oversight of the CRA.

To recap the roles:

- DOF: Develops tax policy, writes the legislation, and prepares federal budgets for the Minister of Finance;
- CRA: Administers the income tax system.

Department of Finance

The DOF is responsible for developing tax policy. Canadian taxpayers (individuals, associations, corporations, etc.) can make recommendations for consideration by the DOF. The government also holds consultative hearings where taxpayers can provide input on subjects and draft legislation.

The DOF prepares the federal budget under the direction of the Minister of Finance. This is traditionally treated as a highly secretive process, particularly because of the potential economic impact. Having advance knowledge of potential tax changes could cause unintended behaviours (i.e. purchase or sale of commodities, restructuring of tax affairs, etc.), resulting in unfair advantages for those who are in the circle of knowledge. A highly confidential development process ensures a fair and level outcome arises from any tax changes.

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Minister of Finance

The **Minister of Finance** presents the federal budget to parliament with a **Notice of Ways and Means Motion**. The legislation is drafted into a **Bill** that is presented to parliament. A motion is made to the House of Commons by the Minister of Finance to accept the Bill that amends the ITA. A second and third reading of the Bill in the House of Commons completes the first part of the process. Once the Bill passes the third reading in the House of Commons, it moves to the Senate where again it goes through three readings. Following the Senate's approval, the Bill moves to the final stage where it receives **Royal Assent** by the Governor General, after which it becomes a law within the ITA.

Income Tax Regulations

Income Tax Regulations do not require parliament's consent; instead, they are enacted through an **Order-in-Council**, which is the federal cabinet. **Regulations** are treated differently than tax legislation because they are more confined to issues that support the legislation.

For example, they are used to describe specific rules related to a piece of legislation. Take, for example, the rules related to a capital dividend. The ITA describes the circumstances when a dividend can be treated as a capital dividend rather than a taxable dividend (subsection 83(2)), while the regulations detail the documents required to be filed with the CRA if a dividend is to be treated as a capital dividend (regulation 2101). In recent years, regulations have taken on an increasingly important role, as they are being used more regularly.

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Amendments

When changes are made to the ITA or *Income Tax Regulations*, the amendments are incorporated into the original text and become a consolidated or amended act.

When federal budgets are introduced to parliament, the CRA will generally begin administering on the new basis even though the legislation has not yet been passed. This typically occurs when there is a strong probability that the legislation will indeed be passed. If, however, there is something that would indicate the legislation may not be passed as originally worded, such as a minority government that opposes the legislation, then there may be some delay in administering based on the proposed legislation.

Interpreting the Income Tax Act

As noted earlier, the CRA's role is to assess income taxes. This involves interpreting the ITA. While many provisions are clear without ambiguity, other provisions may be open to interpretation. One of the CRA's roles is to interpret the ITA, in order to assess taxes that arise.

Later in this course, the process for challenging the CRA's interpretation is discussed.

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Structure of the Income Tax Act

There is a methodical order to the ITA; understanding its layout makes it easier to comprehend the logic behind the Canadian tax system. Financial professionals will benefit from a familiarity with the ITA, as it will add to their understanding of the tax regime as a whole, and its application to client situations.

An online copy of the ITA can be located at http://laws.justice.gc.ca/eng/acts/I-3.3/.

Overview of the ITA

The ITA is divided into over 30 parts. Part I contains the provisions for Income Tax. The table below shows a detailed overview of Part I, followed by a summary of the other parts.

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Part 1 – Income Tax Act

Division A Liability for Tax Section 2	Answers the question "who is liable to pay tax?" Often referred as the "charging" provision.
Division B Computation of Income Section 3 to 108	Computes income for tax purposes (a major part of the base on which the tax is calculated)
Sections 3 to 66.8…	Subdivisions a- Income or loss from an office or employment b- Business or property c- Capital gains and losses d- Other sources of income e- Other deductions (b–e: - Major sources of income and - Deductions in the calculation of Division B income for tax purposes)
Sections 67 to 108…	f- Rules relating to the computation of income g- Amounts not included in income h- Canadian corporations and their shareholders i- Non-resident s/h j- Partnerships and their members k- Trusts and their beneficiaries (i–k: Expands on the rules in "a" through "e" above)
Division C Computation of Taxable Income Sections 110 to 114.2	Contains deducation from Division B income (above) to derive taxable income
Division D Taxable Income Earned in Canada by Non-residents Sections 115 to 116	Rules for non-residents
Division E Computation of Tax Sections 117 to 127.41	Subdivisions a- Rules applicable to individuals a.1- Child tax benefits b- Rules for corporations c-Rules for all taxpayers (Tax rates for individuals and corporations, as well as a variety of tax credits)

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Division E.1 Minimum Tax Sections 127.5 to 127.55	Special Situations, procedural matters and appeals under the Act
Division F Special Rates Sections 128 to 143.3	Special Situations, procedural matters and appeals under the Act
Division G Deferred and Special Income Arrangements Sections 144 to 148.1	Special Situations, procedural matters and appeals under the Act
Division H Exemptions Sections 149 to 149.1	Special Situations, procedural matters and appeals under the Act
Division I Returns, Assessments, Payments, and Appeals Sections 150 to 168	Special Situations, procedural matters and appeals under the Act
Division J Appeals to the Courts Sections 169 to 180	Special Situations, procedural matters and appeals under the Act
Section 180.01	Part I.01 Tax in Respect of Stock Option Benefit Deferral
Section 180.2	Part I.2 Tax on Old Age Security Benefits
Sections 181 to 181.71	Part I.3 Tax on Large Corporations (Pre-2006)
Sections 182 to 183	Part II Tax on Corporate Distributions
Sections 184 to 185(6)	Part III Additional Tax on Excessive Elections
Sections 185.1 to 185.2(5)	Part III.1 Additional Tax on Excessive Eligible Dividend Designations

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Sections 186 to 187	Part IV Tax on Taxable Dividends Received by Private Corporations
Sections 187.1 to 187.61	Part IV.1 Taxes on Dividends on Certain Preferred Shares Received by Corporations
Sections 187.7 to 189	Part V Tax on Penalties in Respect of Qualified Donees
Section 190	Part VI Tax on Capital of Financial Institutions
Section 191	Part VI.1 Tax on Corporations Paying Dividends on Taxable Preferred Shares
Section 196	Part IX Tax on Deduction under Section 66.5
Section 197	Part IX.1 Tax on SIFT Partnerships
Sections 198 to 204	Part X Taxes on Deferred Profit Sharing Plans and Revoked Plans
Sections 204.1 to 204.3	Part X.1 Tax in Respect of Over-Contributions to Deferred Income Plans
Sections 204.4 to 204.7	Part X.2 Tax in Respect of Registered Investments
Sections 204.8 to 204.87	Part X.3 Labour-Sponsored Venture Capital Corporations
Sections 204.9 to 204.93	Part X.4 Tax in Respect of Overpayments to Registered Education Savings Plans
Section 204.94	Part X.5 Taxes under Registered Education Savings Plans
Sections 205 to 207	Part XI Taxes in Respect of Registered Disability Savings Plans
Sections 207.01 to 207.07	Part XI.01 Taxes in Respect of RRIFs, RRSPs, and TFSAs
Sections 207.1 to 207.2	Part XI.1 Tax in Respect of Deferred Income Plans and Other Tax Exempt Persons
Sections 207.3 to 207.4	Part XI.2 Tax in Respect of Dispositions of Certain Properties
Sections 207.5 to 207.7	Part XI.3 Tax in Respect of Retirement Compensation Arrangements
Section 207.8	Part XI.4 Tax on Excess EPSP Amounts
Section 209	Part XII.1 Tax on Carved-Out Income

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Sections 210 to 210.3	Part XII.2 Tax on Designated Income of Certain Trusts
Sections 211 to 211.5	Part XII.3 Tax on Investment Income of Life Insurers
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Sections 211.7 to 211.9	Part XII.5 Recovery of Labour-Sponsored Funds Tax Credit
Setion 211.91	Part XII.6 Tax on Flow-Through Shares
Sections 212 to 218.1	Part XIII Tax on Income From Canada of Non-Resident Persons
Section 218.2	Part XIII.2 Non-Resident Investors in Canadian Mutual Funds
Sections 219 to 219.3	Part XIV Additional Tax (Branch Tax) on Non-Resident Corporations
Sections 220 to 244	Part XV Administration and Enforcement
Sections 245 to 246	Part XVI Tax Avoidance
Section 247	Part XVI.1 Transfer Pricing
Sections 248 to 262	Part XVII Interpretations

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Reading a Provision

Each provision in the ITA follows a sequential referencing system.

Let's consider the example of provision: 70(9.01)(b)(i) (B)(I)

70 section (first number outside of brackets)

(9.01) subsection (second number inside brackets)

(b) paragraph (lower alpha character)

(i) subparagraph (lower case Roman numeral)

(B) clause (upper case letter)

(I) subclause (upper case Roman numeral)

70(9.01)(b)(i)(B)(I) would be read as "sub-clause 70(9.01)(b)(i) (B)(I)" (read numbers and letters in order)

<u>EXAMPLE</u>

Q1: How would you read 110(1)(g)(iv)?

A1: Subparagraph 110(1)(g)(iv)

Q2: How would you read 7(7)?

A2: Subsection 7(7)

Q3: How would you read 3(a)?

A3: Paragraph 3(a). Why? In this example, there are no subsections; instead, the provision jumps directly from this section to the paragraph so it is read as paragraph 3(a).

Amendments to the ITA occur on a regular basis. Rather than renumbering the whole ITA, new provisions are inserted between existing provisions.

- Subsection 148(8.1) appears between subsections 148(8) and 148(8.2);
- Subsection 148(8.2) currently appears between subsections 148(8.1) and 148(9).

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Calculation of Income

Section 3 of the ITA uses a detailed formula to set out the calculation of income. The components are examined in general terms below:

Paragraph 3(a) captures worldwide income from non-capital sources, including office or employment, business, property, and other non-capital sources such as the receipt of a death benefit under C/QPP or support payment.

Paragraph 3(b) captures net taxable capital gains that are not negative.

Note: When allowable capital losses exceed taxable capital gains, the result is a net capital loss →this is deductible in carryover time frames and is captured when calculating taxable income.

Paragraph 3(c) captures general deductions not attributable to any specific source. For example, a deductible spousal or child support payment.

Paragraph 3(d) captures negative amounts or losses from non-capital sources, including office or employment, business, and property.

Section 3 of the ITA can be summarized in the following formula:

3(a) + 3(b) -3(c) -3(d) = income for tax purposes

Income for tax purposes is also referred to as Division B income and is reflected in sections 3 to 108 of the ITA. If you look back to the previous table, you will see Division B, Computations of Income.

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Calculation of Taxable Income

After calculating income for tax purposes, the next step is to calculate taxable income. The formula for this is:

Taxable Income = Income for tax purposes (Division B Income) less Division C deductions

Division C deductions (see Overview of the ITA) are captured in sections 110 to 114.2 of the ITA. Examples of division C deductions include items such as a stock option deduction, capital gains deduction, and net capital loss carry-forward amount.

Calculation of Income Tax

Once you have calculated taxable income, you now have the amount against which you will apply the applicable tax rates to calculate income tax amounts owing.

Division E (see Overview of the ITA) provides details about the computation of tax, including tax rates for individuals and corporations as well as a variety of tax credits.

In summary, for the purpose of understanding the computation of income, it is not necessary to memorize the section numbers; rather, it is more important to understand the major components and concepts, as it will help you to visualize how the tax system works.

The steps to determine income taxes payable are as follows:

- **Determine:** Division B Income (net income for tax purposes)
- **Less:** Division C Deductions
- **Equals:** Taxable Income
- **Apply:** Division E Computation of Tax, including rates and tax credits
- **Outcome:** Income Taxes Payable

Income taxes payable include both a federal and provincial component.

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Administration & Enforcement

The Canadian tax system is a **self-assessment system** that begins with Canadians self-reporting the required information and resulting income tax. The CRA is responsible for administering the income tax system and ensuring compliance by all taxpayers. Administration includes a number of checks and balances in the system. For example, simple things like the CRA's matching of T-slips prepared by employers and companies who issue the slips to employees and investors as a means by which to report payments and withholdings. The CRA receives a copy of T-slips issued by employers and corporations and later matches these submissions with income reported on income tax returns.

The CRA also administers a significant number of initiatives to detect potential cases of tax evasion, fraud, and non-compliance. This includes audits of both individuals and corporations. Below is a discussion of four major initiatives undertaken by the CRA to root out delinquent taxpayers.

- **Foreign Income Verification Statement** – Canada uses Form T1135 (Foreign Income Verification Statement) to capture detailed data related to a taxpayer's foreign-owned property and income. The T1135 form must be completed by Canadian resident individuals, corporations, and certain trusts that, at any time during the year, own specified foreign property costing more than $100,000. As well, there is a reporting requirement for certain partnerships that hold more than $100,000 of specified foreign property. The completed form is due on the same day as the taxpayer's income tax return.
- The term **specified foreign property** is quite detailed but in simple terms captures a wide breadth of properties held outside of Canada (i.e., tangible and intangible property, shares of a non-resident corporation, interest in a foreign insurance policy, etc).

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- **Offshore Tax Informant Program (OTIP)** – This program is designed to detect international tax evasion. It offers substantial financial rewards to encourage individuals to "blow the whistle" on situations where international non-compliance may be occurring. The program targets investments held or transferred offshore and undeclared foreign income and property. The rewards are not limited to Canadians; rather, anyone around the world can benefit by reporting incidences of non-compliance to the CRA. While it is legal for Canadian taxpayers to hold investments outside of Canada, taxpayers must comply with Canada's laws and report income even when earned outside of Canada.
- **Common Reporting Standards (CRS)** – The CRS is a program under which Canada and more than 100 other jurisdictions are working collectively to implement a common international standard for the automatic exchange of financial account information. Under the CRS agreement, financial institutions in each of the participating jurisdictions must report pre-determined information to their country's tax authorities, who in turn are expected to share the information with other participating jurisdictions. The focus is on non-residents who hold financial accounts in countries outside of the jurisdiction in which they reside.

  Under the CRS program, the CRA receives information from financial institutions in Canada about non-residents who hold accounts with them, and the CRA subsequently shares this information with tax administrators in participating foreign jurisdictions. Similarly, financial institutions in other countries are collecting and reporting similar information about Canadians who hold financial accounts in their jurisdiction. This information is being shared with the local tax authorities who, in turn, share the information with the CRA.

  From Canada's perspective, the objective is to use collaboration and information sharing across jurisdictions as a means by which to uncover instances where Canadian residents have not disclosed the foreign assets they own or income they earn and are subsequently not paying their appropriate share of Canadian income tax.

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The type of information being shared between tax authorities includes the name, address, and date of birth of an account holder, account numbers, account balance and amounts paid or credited to an account.

- **Electronic Funds Transfers (EFT)** – The ETF program is another tool being used by the CRA to combat tax evasion. Financial institutions in Canada are required to report all international electronic fund transfers of $10,000 or more to the CRA. In addition, a transfer that involves two or more EFTs of less than $10,000 each that are made within a 24-hour consecutive period by, or on behalf of, the same individual or entity must also be reported to the CRA when the EFTs total $10,000 or more. These requirements are in place for EFTs that are entering and leaving Canada. During the 39-month period between January 1, 2015, when the EFT reporting requirement came into force, and March 31, 2018, more than 187,000 EFTs had been scrutinized.

Statutory Interpretation

The currently enacted tax law (ITA and Regulations) is the ultimate authority for the resulting tax consequences of any situation. The ITA is interpreted and applied against a particular fact situation. Interpreters of tax law are the courts, the CRA, tax advisors, and even individuals. In applying the law, it is commonplace to use court precedents; however, when doing so, it is important to use precedents in respect of the most current law. Changes to statutes through time can override a prior interpretation.

Interpreting Tax Legislation

While every attempt is made to write tax legislation in a clear and concise manner, it is commonplace that the legislation will need to be interpreted. A provision is typically comprised of four main elements:

Person: To whom does the provision apply? Individual, corporation, trust, and partnership? Or, perhaps a combination of persons?

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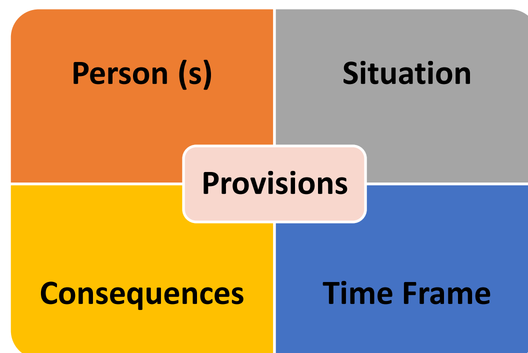
Situation: What is the activity, transaction, or event? Sale of an asset? Transfer of an asset? Interest income? Business expense?

Consequence: What is the consequence of the situation to the person?

Time frame: What is the time frame that applies to the provision, situation or outcome? Over what time frame is the interest income calculated?



Interpreting a provision to identify the four main elements is done through an interpretation of the specific words that make up the provision. Then, the case facts are overlaid onto the words of the provision.

The words of the provision are interpreted through a variety of sources:

a) Definitions in the Act;

b) Cases;

c) Supporting material to assist in interpretation; and,

d) Tax policy.

Definitions in the Act

Words and phrases are defined throughout the ITA. Some definitions apply throughout the ITA while others apply to particular subdivisions, sections, or subsections.

When reading a provision of the ITA, it is important to understand and apply both grammar and punctuation when interpreting the words. A comma, period, and semicolon each contribute to the interpretation. The words "and" and "or," seen often throughout the ITA, can result in very different outcomes.

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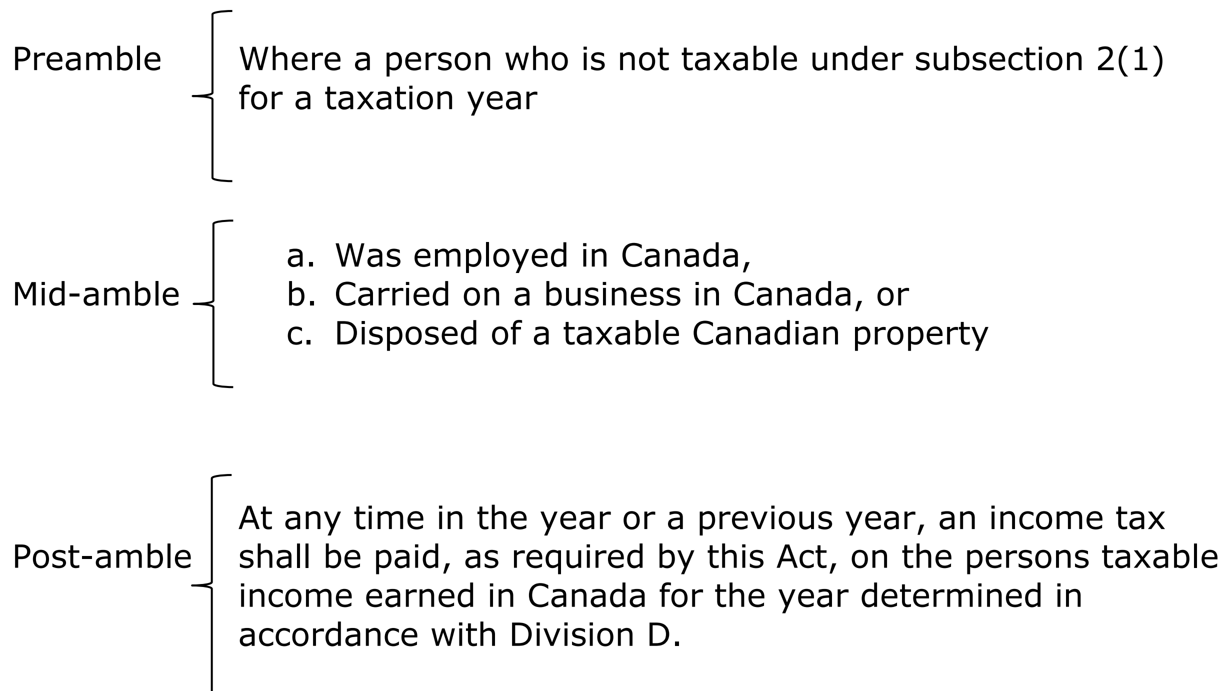
Activity #1

Turn to *subsection 2(3)*, which describes the situation when taxes are payable by a non-resident person.



The preamble describes the person to whom this provision applies. It says the provision applies to a person who is not taxable under subsection 1. Subsection 1 applies to persons resident in Canada at any time in the year; therefore, this provision applies to a person who is not resident in Canada.

The mid-amble sets out three situations separated by the word "or":

- The person was employed,
- The person carried on a business in Canada, **or**
- The person disposed of taxable Canadian property.

The word "or" in the provision after the second situation says that if any of these single independent situations apply, the outcome specified in the post-amble applies.

Note: If the word "or" was replaced by the word "and," the outcome would be different. It would mean that all three independent situations detailed in (a), (b), and (c) would need to be true in order for the post-amble to apply.

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The post-amble describes the time frame during which any of (a), (b), or (c) applied and describes the consequences. The consequence is that income tax must be paid on specific income and it is determined as set out in Division D of the ITA. Division D describes the calculation of taxable income earned in Canada by non-residents.

Activity #2

Go to subsection 248(1) in your ITA. The subsection begins with the words **"In this Act,".** This means any definitions located in subsection 248(1) apply any time the word or phrase appears throughout the Act.

See the term **"active business."**

"Active business," in relation to any business carried on by a taxpayer resident in Canada, means any business carried on by the taxpayer other than a specified investment business or a personal service business" (text from Act).

This means that any time the phrase "active business" appears throughout the ITA, this definition will apply.

Activity #3

Go to subsection 148(9) in your ITA. The subsection begins with the following words:

In this section and paragraph 56(1) (d.1) of the ITA, chapter 148 of the Revised Statutes of Canada 1952.

This means any definitions located in subsection 148(9) apply throughout section 148 in the current ITA and to paragraph 56(1) (d.1) under a previous statute.

The definitions in 148(9) apply to section 148, which is the section of the ITA related to life insurance policies.

Under subsection 148(9), look for the term **"adjusted cost basis."** It is a very long definition that incorporates a formula. This definition applies to the term "adjusted costs basis" anywhere this phrase appears throughout section 148.

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Legal Cases

The national coordinating body for the provincial and territorial law societies, the Federation of Law Societies of Canada, manages a database of court cases and tribunals. It uses the name CANLII (Canadian Legal Information Institute) and is a legal research portal available for free on the Internet.

Decisions of the courts can create binding and non-binding interpretations of the tax legislation. It is important to understand courts do not create legislation. When words and phrases are not pre- defined in the ITA, typically the plain meaning is applied.

Supporting Material to Assist in Interpretation

The CRA and Department of Finance provide a number of publications that can be of assistance with interpretation of tax laws. The Freedom of Information legislation means that many letters and documents produced by the CRA in response to taxpayer inquiries will be released to the public but with personal information redacted from the documents.

CRA Communicating with Taxpayers[1]

The CRA's role is to enforce the provisions of the ITA. The CRA does not set policy nor can it vary from the laws set out in the ITA. However, it interprets the provisions of the ITA and applies that interpretation to its assessments and actions.

Taxpayers can hire professionals to advise them on their income tax affairs. Tax advisors will read and interpret the ITA, and will often look for guidance on how the CRA views the application of certain provisions. Rather than communicate with taxpayers and their tax advisors on a one-on-one basis only, the CRA utilizes several vehicles to enhance communications with Canadians and their tax advisors.

[1] Adapted from Comment, Edition 281 Sept/Oct 2013

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These include:

- Guides and pamphlets;
- Information circulars;
- Technical interpretations letters;
- Advance tax rulings;
- Folios (previously known as Interpretation Bulletins).

Guides & Pamphlets - The CRA publishes many tax guides and pamphlets on a wide variety of subjects. These guides and pamphlets offer information about specialized broad-based topics or specific provisions of the ITA. The guides are typically written with the taxpayer – individual or business in mind and can be easily accessed through the CRA's website. Examples of the types of guides available include Information for Students, Seasonal Workers, and RRSPs.

Information Circulars - An **Information Circular** is a communication resource published by the CRA to explain procedural matters related to the administration and enforcement of the ITA. Available through the CRA's website, Information Circulars can be reviewed using a topical index. For example, the CRA has published an Information Circular that sets out the CRA's administrative requirements and conditions for the registration of Registered Education Savings Plans. The circular is intended for issuers of such plans.

Technical Interpretations - The term technical interpretation refers to the CRA's response to a specific taxpayer's inquiry about an income tax issue. The CRA responds directly to the taxpayer and later publishes its response, with the taxpayer's personal information removed. In this fashion, the entire community of tax advisors can access the CRA's technical interpretation on a tax matter with a specific set of facts. Technical interpretations are not available to the general public but rather are distributed to the tax community through firms that publish tax materials for research purposes. It is helpful to follow the CRA's interpretations by continuously reviewing technical interpretations because it allows tax professionals to monitor the CRA's opinion on particular topics which can, in some circumstances, change over time.

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It is important to note that the CRA's positions are not binding on the CRA for future cases with similar circumstances.

Advance Tax Rulings - A taxpayer may request an advance tax ruling in respect of a proposed transaction that the taxpayer wants to undertake but is seeking certainty about the income tax outcome on a complex issue. The CRA will review the taxpayer's request and respond with a ruling in advance of the transaction. As with Technical Interpretations, the **advance tax ruling** is published by the CRA and available to the entire community of tax advisors. Once issued, the advance tax ruling is binding on the CRA, but only in respect of the particular taxpayer that requested the ruling and only if the transaction in question was completed as described in the ruling request.

Folios - A **folio** is a term used by the CRA for technical publications they prepare on a wide variety of topics. They are a replacement for what was previously known as Interpretation Bulletins, although it will take several years to completely replace the Interpretation Bulletins. Folios provide technical analysis and interpretation of specific tax provisions and are generally intended as guidance for the CRA staff and tax professionals.

There are seven series of folios, each of which covers a broad topic. Within each series, there may be multiple folios. The seven series are:

1. Individuals
2. Employers and Employees
3. Property, Investments and Savings Plans
4. Businesses
5. International and Residency
6. Trusts
7. Charities and Non-Profit Organizations

Folios are available on the CRA's website and present the CRA's interpretation of the law as it applies to each particular topic. See footnote to access these folios.[2]

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[2] Government of Canada, Canada Revenue Authority, (Accessed April 22, 2019) https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index.html)

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The CRA-published documents discussed above do not have the force of law, with the exception of an advance tax ruling that is specific to a client transaction. These documents represent the CRA's interpretation of the related laws.

The CRA can assess a taxpayer based on its interpretation of the law as set out in the ITA; however, if the matter goes before a judge at the Tax Court, he or she will be bound to follow the law, not necessarily the CRA's interpretation. For example, if the CRA takes a position that offers administrative leniency on a particular issue, the Tax Court of Canada cannot apply the CRA's administrative position but rather must apply the law as set out in the ITA.

Taxpayers and their tax advisors should take the time to carefully review the law and the CRA's communications. If the decision is made to rely on an interpretation of the ITA that ignores or disagrees with the CRA's stated opinions, then the taxpayer should be prepared to prove his or her filing position.

Tax Policy

Personal taxes accounted for 28 percent of the federal government's total revenue in 1969. Fifty years later, the 2019 budget forecast indicates that personal taxes will have grown to 50 percent. Corporate taxes are expected to account for almost 15 percent of the total revenue in 2019. Given the heavy reliance on personal income tax through a self-assessment system, taxpayers need to perceive the tax system as fair and equitable in order for the system to operate effectively. As such, tax policy plays a significant role in shaping Canada's tax system.

The concepts of **equity, neutrality, and simplicity** are three fundamental principles essential when developing and drafting tax legislation.

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Equity

Equity can be looked at from a horizontal and vertical perspective. **Horizontal equity** builds on the concept that those with a similar ability to pay should pay a similar amount of income tax. Take, for example, two individuals who both earn $50,000 of income but one earns it through a combination of RRIF income and part-time employment while the other earns it through investments. These two individuals would pay a similar amount of income tax because they have a similar ability to pay – both earned $50,000.

Vertical equity advocates that individuals with a higher amount of income have a greater ability to pay and therefore should pay a greater amount of income tax. A good example of vertical equity is the progressive tax rate system used federally and in most provinces. As individuals earn a greater amount of income, they are taxed on the additional income at a higher rate.

Vertical and horizontal equity are helpful in achieving a system that is viewed as fair.

Neutrality

It is important that the tax system should not influence economic behaviour, which is what we call the concept of **neutrality**. The tax system should not distort natural behaviours that affect economic decision-making. Not all aspects of the tax system are neutral, but the goal should be to strive for neutrality. When the net economic effect of a decision is influenced by the tax consequences, there is a loss of neutrality.

Simplicity

When deciding on tax policy positions and drafting the supporting legislation, **simplicity** becomes another key factor. The ultimate provision should be simple to implement, administer, and understand. An unduly complex system is difficult for taxpayers to understand and increases the likelihood of non-compliance.

In addition, the government's cost of administering a complex system increases.

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Canada and Other Countries

Tax Treaties

A **tax treaty** is an agreement (also known as a **tax convention**) between two countries that creates rights and obligations on the two parties with respect to resolving issues of double taxation and to prevent tax evasion. Treaties do not impose tax but rather are relieving in nature because they are designed to avoid double taxation that could occur if a taxpayer were taxed on the same income in two countries. Treaties establish the parameters within which a country may tax residents of another country. A treaty is relevant when there is a charging provision within a country's domestic tax legislation that applies in the circumstances; otherwise, the treaty cannot be of assistance.

As of November 2018, Canada has:

- treaties in place with 93 countries;
- signed treaties with four other counties that were not yet in force; and,
- negotiations underway with six other countries.

Tax Information Exchange Agreements

Tax Information Exchange Agreements (TIEA), have evolved globally in an effort to create greater transparency in the exchange of tax-related information between countries. A TIEA is an agreement entered into between two jurisdictions setting out the terms for requesting and exchanging tax-related information. Bank information and corporate ownership are examples of the type of information that typically falls within these agreements.

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The growth of borderless economies has created a stronger interdependence between countries that are now working together to reduce tax evasion. This common objective has influenced the evolution of bilateral agreements in which countries set out the levels of cooperation that will apply when exchanging tax-related information as they work together. The result is an unprecedented level of cooperation. There are now fewer countries than ever that are perceived as tax havens because of the rise of global cooperation and pressure.

As of early November 2018, Canada has 24 agreements in effect, one signed but not yet in force, and five others are under negotiation.

Multilateral Instrument

Canada along with 83 other jurisdictions have entered into multilateral tax agreements (referred to as a **multilateral instrument (MLI)**). In very simple terms, countries participating in the MLI arrangement can easily and quickly modify the terms of their tax treaties based on changes negotiated by the Organization of Economic Cooperation and Development (OECD). The result is that when two counties have a treaty and both of those counties have adopted the MLI, any changes negotiated by the OECD will be quickly updated in the terms of the treaty between the two countries. The idea is to reduce the time and effort associated with extensive negotiations that typically go into the development of a treaty between two counties. The MLI concept was developed to help jurisdictions protect their tax base against tax avoidance strategies that use tax treaties to artificially shift profits to lower tax jurisdictions.

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Provincial Issues

Family Law

Family law includes federal and provincial legislation that defines the rights and responsibilities of spouses to each other and their children. A significant amount of case law has also developed in this area, which helps with the interpretation of these laws. Family law can play a critical role in allocating financial assets and liabilities when there are changes in family relationships because of separation or divorce.

Relationships[3]

Married Versus Common-Law - Defining the term **"married**" is quite easy and consistent across Canada because there is a legal definition that applies in every jurisdiction for all programs. This is not the case, however, for the terms "common-law," "family" or "dependent" as these terms can differ by jurisdiction and/or program.

When an individual is legally married, this status is easily verified if required for a particular public or private program. The federal government defines marriage and the provincial/territorial governments have responsibility for solemnizing marriages. Marriage is a legal status acknowledged with a certificate of authenticity to verify its legitimacy.

Two individuals are considered **common-law** for Canadian income tax purposes after one year of cohabitation or immediately upon the birth of a common child if living together. The arrival of a common child, via birth or adoption, is easily established with a clear date for the beginning of the relationship. The beginning date of a common-law relationship, other than because of a common child, is far less definable and open to interpretation and subjectivity because of the lack of formality.

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[3] This section is an excerpt from "Canada's Unit of Taxation: When one plus one shouldn't equal two," 2014, Deborah Kraft.

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The opportunity for selectivity is wide-open in respect of when a common-law relationship begins.

The issue of when a couple begins to **cohabitate** in a common-law relationship is not necessarily easy to define. The issue of "living together" has become the new Canadian standard for many, particularly before taking the step into marriage – if indeed marriage is even a future consideration. The new norm means couples may live together and enjoy the benefits of a couple's relationship, yet may not consider themselves as a common-law couple even though, from the outside world, they appear to fall within the common-law definition for income tax purposes.

The Canadian legal landscape differs immensely in the recognition and definition of common-law relationships. Each province and territory set its own definition of the term common-law for programs and rights under its authority. Generally speaking, there is no common standard for when a province considers a couple to be in a common-law relationship. Provincial issues affected by the definition include spousal support, division of property, and intestacy rights. This means that while a couple's relationship may meet the definition of common-law for Canadian income tax purposes, it may not for other initiatives. It would be remiss for anyone to assume that common-law couples are afforded similar rights to a married couple, except in respect of income tax legislation. This differential could perpetuate misconceptions about the legal status and rights of individuals in a common-law relationship.

Landmark Decisions - In a January 25, 2013 ruling in the case of *Eric v. Lola,* [4] the Supreme Court of Canada (SCC) weighed in on Québec's differing treatment of married versus common-law relationships. The SCC ruled that Québec's law that provides for spousal support on the breakdown of a marriage but not in the case of a common-law relationship does not offend the Canadian constitution and therefore remains legitimate. This outcome supports Québec's position that common-law couples are ineligible to claim spousal support on the breakdown of their relationship.

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[4] Eric v. Lola, Quebec (Attorney General) v. A, 2013 SCC 5.

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In addition, rights in respect of the division of property on a relationship breakdown remain unique to a marriage breakdown and do not extend to common-law relationships. This lack of property rights for common-law relationships is not unique to Québec; several other provinces provide for the division of property rights on a marriage breakdown but do not extend this benefit to common-law relationships. The SCC ruling appears to confirm that, like Québec, other Canadian provinces are within their rights to treat common-law relationships differently than a marriage, particularly those with a civil union or registration option.

In simple terms, the SCC found that the benefits of marriage did not extend to common-law relationships. Although not unanimous, the rationale for the majority decision focused on the fact that choosing a common-law relationship is just that – a choice. The SCC relied on "the principle of freedom to choose between different marital statuses that had different consequences for spouses, and that principle did not in that context infringe the constitutional equality guarantee."[5] In Québec, there is the opportunity for marriage, a civil union or common-law relationship.

Civil Union - The option of a **civil union** arose in June 2002 with the enactment of the Act instituting civil unions and establishing new rules of filiation, designed to provide same- and opposite-sex couples with an option other than marriage. The Act, which pre-dates same-sex marriage in Canada, sets out conditions and obligations with which couples opting for a civil union need to comply. The objective was to create a legally recognized marriage-equivalent relationship with marriage-equivalent benefits, in all respects. As such, the conditions for forming a civil union mirror the conditions set out in Québec for a marriage.

In arriving at the decision, the SCC gave careful and specific thought to the Québec government's intention in the establishment of civil union legislation. The SCC noted that "they were enacted as part of a long and complex legislative process during which the Québec National Assembly was concerned about keeping step with changes in society and about adapting family law to new types of conjugal relationships in a manner compatible with the freedom of spouses."[6]

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[5] Ibid. p. 219
[6] Ibid. p. 267

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The SCC also considered the issue that perhaps a participant in a common-law relationship is simply unaware and does not understand the longer-term implications of the choice to remain in a common-law relationship without taking the legal step of a civil union or marriage. The SCC opined that "it is not unreasonable to believe that, in theory, individuals sometimes make uninformed choices and that some individuals may be unaware of the consequences of their choice of conjugal lifestyle. Nevertheless, to take judicial notice of the fact that the voluntary choice not to marry does not reflect an autonomous decision to avoid the legal regimes would be to exceed the limits of legitimate judicial notice."[7]

While this could suggest that the majority discounted the concept of an uninformed choice, the analysis places a significant emphasis on the individual's autonomy to make personal choices. The significance of the SCC decision is found in acknowledgment and respect for the freedom of individuals to make a conscious choice to remain outside of the legal regimes of marriage or a civil union. The SCC explained that if their decision that respects the freedom to make autonomous choices perpetuates social issues such as uninformed choices, then it is up to the legislature to address the social issue through legislation.[8]

Other Jurisdictions - On March 18, 2013, British Columbia's (BC) new Family Law Act extended to common-law partners the same rights, responsibilities, and protections afforded to married couples. This includes items such as property rights, spousal support, and pensions. The legislation does not use the term "common-law" but rather defines a couple to be spouses when they have "lived together in a marriage-like relationship" for a continuous period of two years. There is also an immediate spousal relationship in situations where there is a common child to a couple living together.

While the legislation was prompted by the BC government's interest to update laws to better reflect new and evolving relationships, the new definition leaves a lot open to interpretation and selectivity depending on the circumstances.

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[7] Ibid. p. 274

[8] Ibid p. 274-276

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It is likely that the courts will face the challenge of interpreting the definition based on unique circumstances. Questions such as – what was the couple's intention? What behaviours should be considered when assessing a marriage-like relationship? Do these behaviours change over time?

The difficulty, of course, is that relationships and living arrangements have changed over time; but so have the behaviours on which the relationship may be judged. For example, a change from single to family coverage for health benefits might have been an indicator of a marriage-like relationship in the past. Today, because employers often only pay for single coverage, individuals are more likely to each retain single coverage rather than assuming unnecessary additional costs for family coverage. The evolving concept of "friends with benefits" – those living together and enjoying a close personal relationship but with no strings attached – will likely lead to great debates. In the past, the relationship might be perceived as a conjugal relationship when judged by a particular generation; however, how might the younger generation view the relationship?

Three-Years of Cohabitation - In Alberta, the term **"adult interdependent partners"** was introduced in 2003 to define common- law relationships recognized in that province. Three years of cohabitation is required for recognition of common-law status or a child in common where the couple live together. In general terms, Alberta's legislation extends beyond conjugal relationships and offers legal status to close-personal relationships where there is emotional and financial interdependence between two non-married individuals living together, including family members or friends. Alberta has developed its own version of an economic unit.

Ontario and New Brunswick utilize a three-year period of continuous cohabitation in order to recognize a common-law relationship for spousal support but provide no recognition for property rights. Nova Scotia legislation requires a two-year period of cohabitation for recognition of common- law status. Ontario couples who live together and have a child in common are deemed to be common-law in terms of rights and responsibilities, regardless of the length of time they have lived together.

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The above discussion looks at the difficulty of establishing when relationships begin; however, at the opposite end of the spectrum is the difficulty of clearly establishing when a relationship ends.

While each jurisdiction sets their own rules, the lack of formal, consistent proceedings in respect of defining the end of a common-law relationship adds uncertainty and selectivity to the issue of "if" and "when" the relationship ceased.

Child Support

Responsibility relating to child support is a shared responsibility between the federal and provincial/territorial governments. In general terms, federal child support guidelines apply when the individuals are already divorced or planning to divorce. Provincial and territorial laws apply to child support when the couple is married and planning to separate (but not divorced) or the couple is not married and is now separated or planning to separate.

Canada's justice system has a wealth of resources available related to divorce and separation.

See footnote for more information about child support payments under federal jurisdiction along with the opportunity to enter data to calculate the base amount of child support payments.[9] There are also provincial support guidelines, and while they are similar in most provinces, there can be some differences.

In addition to regular child support payments, parents may also be required to contribute to "special" or "extraordinary" expenses such as post-secondary education, health-related expenses, and extracurricular expenses such as sports or music lessons.

Parents can create their own agreement with respect to child support payments.

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[9] https://www.justice.gc.ca/eng/fl-df/child-enfant/cst-orpe.html

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Government of Canada, Federal Child Support Guidelines

Getting Divorced

If you are getting divorced and you will pay or receive child support and	Then
You and the other parent both live in: • Alberta • British Columbia • Newfoundland and Labrador • Northwest Territories • Nova Scotia • Nunavut • Ontario • Prince Edward Island • Saskatchewan • Yukon	The ***Federal Child Support Guidelines*** apply to you.
You and the other parent both live in: • New Brunswick • Manitoba • Quebec	***Provincial Child Support Guidelines** apply to you.*
You and the other parent live in different provinces or territories	*The **Federal Child Support Guidelines** apply to you.*
One parent lives in Canada and the other parent lives outside Canada	*The **Federal Child Support Guidelines** apply to you.*

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When You Are Not Married

If you or the other parent	Then
Are not married to each other	***Provincial or territorial child support guidelines*** apply to you.
Are married, have separated, but are not planning to divorce	***Provincial or territorial child support guidelines*** apply to you.

Source of these tables: Government of Canada, Federal Child Support Guidelines.

When working on family-related issues as part of a financial or estate plan or simply providing guidance to a client, it is essential to understand this can be a complex area. Collaborative working relationships with the client's other advisors are always in the best interest of the client. For more information go to https://www.justice.gc.ca/eng/fl-df/child-enfant/index.html

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Family Law Concepts

Domestic Contract

A **domestic contract** is entered into by cohabitating individuals designed to address issues relating to their relationship, including support and property issues. Examples include a marriage contract as well as cohabitation, separation, family arbitration, and paternity agreements. To be valid, the contract/agreement must be in writing, signed by the parties, and witnessed.

EXAMPLE

Montreuil v. Montreuil

In this case, divorcing spouses negotiated and signed a separation agreement, which the wife attempted to set aside on the basis that her husband knowingly misrepresented the value of his RRSPs and his interest in a marina property. The wife had relied on the information her husband had given her in regard to these assets. The Court found that the husband had indeed made misrepresentations, and that the wife would not have signed the separation agreement had she realized the true value of the assets. The Court set aside the separation agreement pursuant to the Family Law Actand the common-law doctrine of material misrepresentation.

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Division of Family Property

For the purposes of family law, property is broadly defined and can include any present or future interest in real or personal property, whether vested or contingent. Family property can be defined as the assets of spouses that are subject to division on marriage or relationship breakdown; such division is generally governed by provincial law.

EXAMPLE

Walsh v. Bona

This case involved a Charter challenge to the Nova Scotia Matrimonial Property Act (MPA). This statute does not include heterosexual common-law relationships in its definition of marriage, such that its property division provisions apply only to married couples. At issue in the case was whether this omission violated s. 15 of the Charter. The SCC held that it did not, explaining that it did not affect the dignity of unmarried persons who have formed relationships of some permanence and did not deny them access to a benefit or advantage available to married persons.

Valuation Date

The **valuation date** is the date when the parties separated with no reasonable prospect of resuming cohabitation. This date is used for purposes of calculating the value of net family property (i.e. the value used is the FMV of the asset as of valuation day).

Value

Though value is not defined in the applicable legislation, it is generally considered to mean FMV.

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Unjust Enrichment

A common-law spouse not entitled to a division of property by statute may claim an interest in property through the principle of **unjust enrichment**. The spouse must show that he or she has made a contribution that has enriched the other spouse and that there is no legal reason for the enrichment.

EXAMPLE

Peter v. Beblow

At issue in this case was whether contributions made by a common-law spouse (Peter) during the parties' 12-year relationship could form the basis for a constructive trust such that she was entitled to the home the parties had lived in. Her contributions included all domestic duties related to the family, including raising the parties' children. As a result of these contributions, the other spouse (Beblow) was able to pay off the mortgage on the family home and also purchase a houseboat and a van, among other items. The SCC held that a constructive trust existed and that Peter should be awarded the property.

In its decision, the SCC discussed the principle of unjust enrichment in the context of a spousal relationship. It found that in determining whether an unjust enrichment exists, it must be considered whether there is any juristic reason (i.e. reason in law) for the enrichment. It noted that generally, a common-law spouse owes no duty at common-law, in equity, or by statute to perform work or services for the other spouse, and that it is not unfair for a recipient of indirect or non-financial contributions to be forced to provide recompense for those contributions, noting also that domestic services cannot logically be distinguished from other contributions.

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Matrimonial Home

The **matrimonial home** is a residence in which spouses carry on their ordinary pattern of family life.

EXAMPLE

Rapp v. Wagman

At issue in this case was whether a home lived in, but not owned by, a married couple could be considered a matrimonial home. The owner of the home was the husband's mother (Rapp). Her son and his wife (Wagman) lived there together until their separation. Rapp applied for a declaration that Wagman had no interest in the property; she had allowed her son and Wagman to reside in the home under a licensing agreement and not as tenants. On their separation, Wagman registered a claim against the home as a matrimonial property. The Court found that the licensing agreement granted by Rapp to her son and Wagman was in the nature of a lease, such that they were tenants, and allowed Wagman's claim that the property was a matrimonial home.

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Child of the Marriage

For federal law purposes, a **child of the marriage** is one who is under the age of majority and in the parents’ charge by reasons of illness, disability, or other causes; it may also include a child in full-time attendance at an educational institution. In addition, the Divorce Act provides that any child for whom a spouse has stood in the place of a parent is considered a child of marriage. Under provincial family law, there is a similar obligation to support a child whom the spouse has treated as a child of her family, regardless of whether there is a biological or adoptive relationship.

EXAMPLE

Chartier v. Chartier

The wife had a child from a previous relationship. The husband played an active role in caring for the child but did not adopt the child. On divorce, the husband wanted to sever his relationship with the child, but the Court held that he could not do so unilaterally when the evidence supported his parental relationship to the child. As a result, the husband was required to pay child support.

Split Custody

Split custody is a custody arrangement in which each parent has custody of one of the children. Essentially, this means there is more than one child and the children are split up between the parents.

Spousal Support

Spousal support is payments made by one spouse to another after a relationship breakdown. The payments are meant to ensure that the recipient spouse partakes in the payor spouse’s wealth to the extent that such wealth, or earning power, accrued to the payor during the marriage.

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EXAMPLES

Moge v. Moge

At issue in this case was whether a court could terminate spousal support payments on the grounds that a recipient spouse was not able to reach a level of self-sufficiency. The couple in the case, Andrzej and Zofia Moge, separated in 1973 and eventually divorced. Zofia had been a housewife during the marriage and had many difficulties finding work once separated. She worked at a hotel as a maid but eventually lost her job. Andrzej paid child and spousal support, but once Zofia lost her job, she applied for an increase in spousal support. When Zofia found another job, Andrzej applied to have the support terminated. The Court held that the grounds for cancellation were insufficient, and although one of the objectives of spousal support is self-sufficiency, it does not subject the spouse to a “sink or swim” philosophy. The Court instead proposed that cases be considered on the merits of the recipient’s economic status that are a result of the marriage breakdown.

Bracklow v. Bracklow

In this case, the SCC declared that spousal support can be “non-compensatory” or “needs-based,” and continue for years despite a relatively short marriage. The parties were married for seven years. At the time of marriage breakdown the wife was ill; she eventually became permanently disabled and was unable to obtain employment. She was living on a disability pension of $846 per month while the husband earned $71,000 per year. The SCC held that the wife was entitled to support based on her need alone, and that the husband’s obligation to pay support could be ongoing. It ordered the BC Supreme Court to decide the amount and duration of support, which ordered the husband to pay $400 monthly for five years. In deciding the amount, the Court weighed the factors set out in the provincial statute, stating that the award was fair to both parties and describing it as “an attempt to reflect the requisite balancing of several diverse and competing factors.”

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EXAMPLES (CONT'D)

Miglin v. Miglin

In this case, the wife waived spousal support in a separation agreement, while at the same time entering into a five-year consulting agreement with her spouse under which she was paid an annual fee. When the consulting agreement was not renewed, the wife applied for spousal support, asking the Court to disregard her earlier waiver. The SCC found that when determining whether an agreement should be waived, the courts must review the circumstances under which it was created, including whether there was professional assistance in drafting the agreement, whether the agreement still reflected the parties' original intent, and whether it met the objectives of the Divorce Act. After reviewing the relevant circumstances, the Court concluded that the spousal support waiver in the separation agreement was valid.

Desramaux v. Desramaux

A separation agreement provided the wife with time-limited spousal support and relieved the husband from any further obligation thereafter. The wife had given up her career for her husband and had very limited ability to earn income. By contrast, the husband earned over $100,000 annually. The Court set aside the wife's waiver of ongoing spousal support on the grounds that it resulted in unconscionable circumstances.

Child Support

In general terms, **child support** is the payments made by the non-custodial spouse to the custodial spouse as contributions to the support of the children of the relationship. The federal government has established Child Support Guidelines, which help parties/courts calculate the appropriate amount of child support that a parent should pay, considering factors such as income, need, etc. Provincial child support guidelines can apply for children of common-law relationships.

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EXAMPLES

Francis v. Baker

The father earned approximately $945,500 annually and had net worth estimated at $78 million. He was ordered to pay monthly support of $10,034 for two children in accordance with the Child Support Guidelines. He appealed the order, which was upheld by the SCC. Though the Court concluded that in some cases the support payable under the federal guidelines might be so in excess of a child's reasonable needs that it is in effect a functional wealth transfer to the custodial parent, in this case the level of discretionary expenses for the children were appropriate relative to the financial ability of the father.

R. v. R.

The father's annual income was approximately $1 million before separation and $4.1 million after separation. Based on this income, the federal guidelines suggested the amount of approximately $65,000 monthly as an appropriate amount of support for four children. The Court found that $32,000 monthly was a more appropriate amount in the circumstances.

Bankruptcy Legislation

In simple terms, bankruptcy is a process through which individuals who are financially insolvent apply to be released from their financial obligations.

Topics in this section include:

- Informal discussions;
- Consumer proposal;
- Division I proposal; and,
- Filing bankruptcy.

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Informal

Informal discussions with creditors can be an option and can often lead to a satisfactory outcome for both the individual and the creditor. However, when informal discussions do not meet the needs of those involved, another option for individuals who have debts totaling less than $250,000 is a consumer proposal.

Consumer Proposal

A **consumer proposal**, governed under the Bankruptcy and Insolvency Act, involves a bankruptcy trustee who works with a financially insolvent individual to prepare a plan that provides for:

- Repayment to creditors of a percentage of the debt owing; and/or
- An extension to the period over which debts may be repaid.

The trustee oversees the plan and manages the payments to creditors. The proposal is sent to creditors. One or more creditors who individually or together are owed 25 percent or more of the value of the financial claims can request a meeting of the creditors. As well, the Office of the Superintendent of Bankruptcy has the option to call a meeting. A vote takes place at the meeting, with the vote based on dollar value of the amount owed to the creditor.

If no creditors request a meeting within a specific period of time, then the proposal is deemed accepted. If not accepted, the trustee and individual could refine and resubmit the proposal. If ultimately the proposal is not accepted, the individual may have to declare bankruptcy.

Overall, the process is fairly simple and individuals are able to retain all of their assets and actions by an unsecured creditor cease (i.e. garnishment of wages). Using this option allows individuals to realign their financial stability without the need for declaring bankruptcy.

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Division I Proposal

A **Division I Proposal** is another option under the *Bankruptcy and Insolvency Act*. This option looks similar to a consumer proposal, but there are no limitations in terms of total debt. Under this option, a meeting of the creditors is an automatic requirement. Creditors vote on the proposal and acceptance of the proposal is based on specific percentages established in the legislation. If accepted, the proposal goes before the courts for approval and all unsecured creditors are bound by the proposal. If the proposal is not accepted by the creditors, based on the required votes, the individual is declared bankrupt as of the date of the creditor's meeting.

Filing Bankruptcy

To file **bankruptcy**, an individual meets with a trustee and completes the required forms. The trustee files the forms with the Office of the Superintendent of Bankruptcy and the individual is declared bankrupt. From that point forward, the trustee deals with the individual's creditors and sells the individual's assets. After having filed bankruptcy, individuals are required to attend two mandatory financial counseling sessions focused on helping the individual understand the cause of the bankruptcy and to understand how to gain a stable financial foothold for the future.

If an individual has a steady flow of income, they may be required to make surplus income payments. This is a standard threshold set annually by the Office of the Superintendent of Bankruptcy. Currently, if surplus income is greater than $200 per month, the individual is required to contribute 50 percent of that amount.

A **discharge of bankruptcy** is the term used when an individual is released from the legal obligation to repay debts owed on the date the individual filed for bankruptcy. The timing for a discharge depends on the individual's specific circumstances and whether surplus payments are required.

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While filing bankruptcy releases individuals from many of their financial obligations, there are some obligations that are not extinguished. Debts that continue as financial obligations and are not eligible for discharge include:

- Student loans if the individual has been a full-time or part-time student within seven years of having filed for bankruptcy;
- Alimony payments;
- Child support payments;
- Debts arising because of fraud; and,
- Court-ordered fines or penalties.

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Contract Law

Contract law deals with situations in which two or more parties exchange legally binding promises. Though contract law is primarily based on common law, specific types of contracts can be governed by statute.

This section assumes that candidates have completed the CFP education program as prerequisite knowledge.

Contract Law Concepts

The following is a series of terms together with their definition and related examples of important concepts fundamental to contract law. Keep in mind that a contract is intended to be an agreement that is enforceable by the courts.

Offer

An offer is a statement of terms under which the offeror (person making the offer) is willing to create a binding agreement with another party. To be valid, the offer should contain all relevant terms of the contract and be clear and unambiguous. Most offers are considered valid if communicated in writing or verbally.

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EXAMPLE

Bolton Estate v Allstate Insurance Co. of Canada

An insured wrote a letter to his insurance company requesting cancellation of his life insurance policy. The insurer received the letter but the insured died before it could respond. The insurer declined a claim for benefits from the beneficiaries because of the letter it had received. Considering that the premium for the policy had been paid to a date beyond the date of death, the Court held that the letter of cancellation was an offer to which the insurer had not responded and ordered the death benefit to be paid.

Tender

Tender is a firm offer to parties to bid on work.

Acceptance

An acceptance is an expression of agreement to the terms of an offer. A contract cannot be formed unless the offer is accepted in its entirety. For example, assume A makes an offer to purchase B’s home for $400,000 along with a series of other conditions. If B finds all the terms and conditions acceptable, he or she can express agreement by signing an acceptance. If B makes any changes, there is not an expression of agreement in its entirety.

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EXAMPLE

Rancourt v. Canada Trust Co.

In this case, a husband and wife signed a credit card acceptance form received in the mail and proceeded to use the card. The issuer of the card (Canda Trust Company) sought payment from the wife with respect to a debt the husband incurred on the card without the wife's knowledge. The Court held that the acceptance form constituted an offer to provide credit to the to whom the offer was directed. The wife and husband accepted the offer by signing the form. There was no issue as to whether there was adequate consideration. The Court therefore concluded that a contract existed and the wife was bound by the terms of this contract to pay the debt on the card.

Consideration

To make a valid contract, both parties must agree to exchange something of value which is referred as consideration.

EXAMPLE

Albert Drywall Supply Ltd. v Hauk

The issue in this case was whether consideration passed between the parties to an agreement such that a contract was formed. The owners and shareholders in a family--owned drywall business (Cougar) granted a mortgage in favour of a creditor (Drywall). Though a shareholder of COugar (Alfred Hauk) had previously signed a personal guarantee for the debt, Drywall was not satisfied that this was enough; it agreed not to sue on the debt if the Hauks would grant the mortgage. When the Hauks declared personal bankruptcy and Cougar ceased doing business, Drywall moved to foreclose on the mortgaged property to satisfy the debt. The Hauks claimed a contract had not been formed, because there was no consideration given for the mortgage. The Court disagreed, finding that Drywall agreeing to not sue Cougar for payment of the debt in exchange for the mortgage amounted to consideration.

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Seal

A contract under seal does not require consideration. Further, when a contract is executed under seal, an undisclosed principal can neither sue nor be sued with respect to the contract. Corporations often have corporate seals and apply the seal to a contract along with signatures of the designated signing officer(s). Some companies such as banks or insurance companies may require the corporate seal be applied to some contracts, particularly when the application or contract has the signature of only one signing officer. The word "seal" written on the contract has the same effect as a legal seal. The purpose of using a seal is to ensure validity of the contract.

EXAMPLE

Friedmann Equity Developments Inc. v Final Note Ltd.

In this case, a corporation was created to hold legal title to property as a trustee/agent for the beneficial owners. A mortgage registered against the property was executed, the mortgage agreement signed by the corporation's authorized officer under its corporate seal. When there was a default on the mortgag, the mortgage commenced an action against the beneficial owners, who were not parties to the mortgage. The beneficial owners claimed that they could not be sued on the contract executed by their agent under seal. The Court agreed, holding that though as a general rule an undisclosed principal can sue or be sued on a simple contract entered into on his behalf by an agent, the sealed contract rule is an exception to this rule. The exception stems from the rule that only parties to a sealed instrument have obligations and rights under it.

Objective Meaning

The concept of 'objective meaning' relates to the process used when interpreting the terms of a contract; their objective meaning will be preferred over the subjective meaning (based on observable facts rather than opinions or interpretations).

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Context

Applied to contract law, context means that a court can interpret a contract based on its context, such as the applicability of the contract to the parties' particular type of business.

Implied Term

A term may either be expressed or implied. An expressed term is stated by the parties during negotiation or written in a contractual document. An implied term is not stated but nevertheless forms a provision of the contract.

Severability

Where a particular provision of a contract is ambiguous, impractical, or illegal, the court may sever that provision from the contract and enforce the contracts remaining terms.

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Parol Evidence Rule

The parol evidence rule provides that oral terms and other extrinsic evidence do not override the terms of a written contract.

EXAMPLE

Michael v. Sharma

The issue in this case was whether the Court, in interpreting the terms of a contract, could review extrinsic evidence not part of the written agreement. Michael was retained by Sharma to perform certain legal services and the parties signed a retainer agreement providing for a $2,000 payment. On termination of the relationship, Michael invoiced Sharma for approximately $10,000, claiming these accounts were prepared at his hourly rate of $150, the rate referred to in the retainer agreement. Sharma said the fixed fee of $2,500 and sought to introduce transcripts of parties' recorded conversations concerning their agreement. Michael contended the parol evidence rule prevented the use of transcripts because the retainer agreement clearly outlined all relevant terms, while Sharma contended that the retainer agreement was ambiguous with respect to the fees. The Court held that the discussion of the fees was an indication of the intention of the parties and the parol evidence rule did not exclude that kind of evidence. It also found that the retainer agreement did not constitute the full agreement between parties and the transcripts should therefore be admissible as evidence.

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Contra Proferentum

The contra proferentum rule provides that an ambiguous term in a contract should be interpreted against the party who drafted the contract.

> **EXAMPLE**
>
> ***Henning v. Clarica Life Insurance Co.***
>
> This case involved the determination of whether an insurer paying disability benefits could deduct from these benefits the amount of CPP child benefits paid as a result of the insured's disability. The Court held the insurer could not deduct the CPP children's benefit, holding that the contract of insurance was ambiguous and, as such, the proferentum rule applied (i.e. an ambiguity in an insurance contract should be resolved in favour of the insured). It also accepted the interpretation that better accorded with the intention of the parties, because it was unlikely that a low-income person with dependent children would enter into a contract that would pay her little or nothing after the CPP-related deductions.

Exclusionary Cause

An exclusionary clause is intended to limit liability, but may be found to be invalid. For example, a business that enters into a contract with a consumer cannot automatically exclude itself from all liability.

> **EXAMPLE**
>
> ***BC Ferry Corp. v. Commonwealth Ins. Co.***
>
> In this case, a ferry company claimed indemnity from its insurer for property damage suffered as a result of a storm. The insurer did not pay, relying on the contract's exclusion clause for flood damage. The Court held that the damage was caused by waves battering the terminal but not by a flood as defined in the policy. As a result, the damage suffered by the ferry company fell within the coverage of the policy, and the insurer had to pay the claim.

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Breach

A breach of contract occurs if one party fails to perform its obligations or prevents the other party from performing. A party may breach a contract by expressly repudiating its liabilities or by failing to fulfill the terms of a contract.

EXAMPLE

Trio Roofing Systems Inc. v. Atlas Corp.

The issue in this case was whether a subcontractor (a roofer) could refuse to honour a contract with its general contractor because the contractor had failed to pay the subcontractor for a previous contract; in other words, whether a fundamental breach by the contractor in honouring the terms of one contract can amount to an anticipatory breach, the Court stated the following:

Anticipatory breach occurs when a party, by express language or conduct, as a matter of implication from what he has said or done, repudiates his contractual obligations before they fall due. The conduct of the party who has broken the contract is such that the other party is entitled to conclude that the party breaching the contract no longer intends to be bound by its provisions. The authorities reveal that for this type of breach to occur the following must be established: (1) conduct which amounts to a total rejection of the obligations of the contract; (2) lack of justification for such conduct. If, to these, is added the acceptance by the innocent party of the repudiation, then the effect will be to terminate the contract. This does not mean the repudiating party is free from all liability. It simply means that the innocent party may be freed from his obligations (as in the case of a breach at the due date of performance), and may pursue such remedies as would be available to him if the breach had taken place at the time when performance was due.

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Mistake Void & Voidable Contract

A mistake in the context of contracts means that, at the date of the contract, one party did not make the bargain she thought she was making.

EXAMPLE

Bank of Nova Scotia v. Kostuchuk

In this case, a man (Kostuchuk) borrowed money from a bank for his friend, assuming the friend was making payments on the loans. When the friend defaulted on the loans, the bank sued Kostuchuk. It was clear that Kostuchuk did not receive the proceeds of the loan and personally did not know that the loans were in his name, He was also not aware that eh loans were not being repaid by the friend. The Court found that Kostuchuk did not have to repay the bank, as he did not understand the duties he assumed when contracting with the bank.

Capacity to Contract

The capacity to contract is the ability to understand and make a contract. Issues relating to capacity are associated with minors or adults with a diminished mental ability.

EXAMPLE

Hann-Byrd Estate

This application involved the capacity of a 10-year-old child actor to enter into a contract to perform in a film. The application was made by the producer of the film (i.e. the other contracting party) with the approval of the child's parents. The Court held that he did not have the capacity. It also discussed the legislation under which the Court could grant that the child had capacity, including that the Court must be satisfied that the contract is for the benefit of the child and that the child is not in need of the protection offered by the law to children in such matters.

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Privity of Contract

The principle of privity of contracts provides that only parties to a contract can sue to enforce their rights or claim damages.

Illegal Contract

Illegal contracts are contracts that are rendered illegal by statute. Such contracts are void and cannot be enforced.

EXAMPLE

Commercial Life Assurance Co. v. Drever

In this case, a man held himself out as a real estate agent and accepted employment as such in the face of statutory prohibition. As he was prohibited by law from these services, the contract he relied on (in which he undertook to provide the services) was determined to be illegal.

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Contract Against Public Policy

A contract against public policy is a common law rule providing that a contract cannot offend public policy.

EXAMPLE

Oldfield v. Transamerica Life Insurance Co. of Canada

In this case, a man who had swallowed bags of cocaine for the purpose of illegally smuggling them out of South America died when one of the bags ruptured. He had a life insurance policy, with his wife as a beneficiary, but the insurer did not pay, claiming that the widow was precluded from receiving the proceeds on the grounds that a person should not be allowed to insure against his or her own criminal act irrespective of the ultimate beneficiary of the insurance policy. The main issue to be determined was whether the rule of the public policy against criminals benefitting from their own crimes applied in this case. The Court held that it did not apply, at least in part, because the benefit did not accrue to the criminal but to the named beneficiary. The wife's claim was held bona fide; she had no part in the crime and her interest arose before the crime.

Misrepresentation

To misrepresent is to represent incorrectly. A misrepresentation made during the negotiation of a contract may lead to the contract being set aside if it is considered material to the contract.

Fraud

Fraud is intentional misrepresentation of a matter material to the establishment of a contract.

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Frustration

Frustration involves a change not contemplated by the parties that makes performance impossible or impractical. Examples include third-party interference, illness of one of the parties, or unexpected change in the laws. Circumstances considered as foreseeable are not acceptable when applying the principle of frustration.

EXAMPLE

Saturley v. Lund

In this case, a couple who agreed to buy a house claimed that the contract was frustrated when they could not sell their own house because on an oil leak. They claimed the contract had an implied condition that they did not have to complete the purchase of the house they agreed to buy if they could not sell their own, and that it was not possible for them to fulfill this term of the contract would alter the fundamental nature of the contract in light of the changed circumstances. As this was not the case here, the Court held that the doctrine should not be applied.

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Unconscionability

Unconscionability is a principle that allows a court to set aside a contract that is unfair. It often involves a situation in which there is an inequality of bargaining power.

EXAMPLE

Scheel v. Henkelman

This case involved the interpretation of unconscionability as that term appears in the Ontario Family Law Act in relation to a domestic agreement. The parties were common-law spouses who had entered into a contract in which both waived their rights to claim for support from the other. The Court held that the issue was not whether the contract was unconscionable when entered into, but rather whether it resulted in unconscionable circumstances, which this contract did within the context of the Ontario *Family Law Act*.

Undue Influence

Undue influence occurs when one party influences another to the extent that the influenced party has not made an independent decision.

EXAMPLE

Tribe v. Farrell

In this case, an 83-year-old man (Tribe) employed a much younger (48-year-old) woman (Farrell) to do light housekeeping and other related duties in his home in exchange for room and board. After a number of years, Tribe became dependent on Farrell. He also executed a new will in which he left his house to Farrell (though he had living relatives) and signed a power of attorney in Farrell's favor. In the circumstances, the court held Farrell exercised undue influence on Tribe.

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Performance

The act of fulfilling one's duties under a contract is known as performance; ideally, a contract ends when both parties have performed their contractual duties.

EXAMPLE

Fraser Valley Title Search Ltd. v. Gallagher

The plaintiff sued the defendant/purchaser, James J. Gallagher, for specific performance of an agreement to purchase certain lands situated near Campbell River, British Columbia, or damages in lieu thereof. The parties agreed that the vendor was at all times ready, willing, and able to complete the transaction and that the purchaser was unable to complete by reason of insufficient financing and hence repudiated the agreement.

The following issues were left to be resolved by the Court:

- Upon the purchaser's repudiation of the agreement to purchase, the vendor is required to elect between two inconsistent rights - the right to accept the repudiation or the right to affirm the contract. Should the vendor exercise his right of election to accept the repudiation, that relieves both parties from further performance under the agreement, and the vendor may claim damages flowing from the breach.
- On the other hand, where, as in this case, the vendor exercises its right of election to affirm the contract, the contract then continues to exist for the benefit of both parties, and the vendor has the right to elect between two *alternative* remedies, specific performance of the contract and indemnity for consequential damage resulting from the delayed performance or, alternately, damages for the breach.

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Waiver

Both parties may agree to end a contract. If the parties still have obligations under the contract, mutual consideration exists if they agree to end the contract, and the agreement to waive is then enforceable. When a party to a contract voluntarily and knowingly renounces his or her right, it is also known as a waiver.

EXAMPLE

Blomberg v. Blackcomb Skiing Enterprises Ltd.

In this case, an injured skier who had signed a waiver releasing a ski hill from liability in the event of injury claimed the waiver was invalid and that he was entitled to damages suffered as a result or his injuries. The Court decided in the ski hill favour, holding that the skier understood the nature of the waiver and its consequences.

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Novation

Novation is a term used to describe the act of either replacing an obligation to perform with a new obligation, or replacing a party to an agreement with a new party. Both parties to the contract must agree to the change.

EXAMPLE

Sun Life Trust Co. v. Kashwest Investment Ltd.

The issue in this case was whether an extension agreement with respect to a mortgage amounted to a novation of the original mortgage agreement. The mortgaged property was owned first by Kashwedt, then by Charles Walters (Walters), and then by a numbered company (Numberco) owned by Walters. When Numberco defaulted on the mortgage, the property was sold, and the mortgages (Sun Life) sued Kashwest, Numberco and Walters for the deficiency owing. walters argues the defence of novation, claiming that when Sun Life entered into the extension agreement, it accepted as a substitution for life original mortgage, and therefore it was Numberco, not Walters himself, that deficiency. However, the court found that Sun Life had included specific terms in the extension agreement that clearly indicated it did not intend the agreement to replace the original mortgage, including a preservation of rights clause and a no prejudice clause. The Court therefore held that extension agreement could not be viewed as a new contractor or a release of liability, and that novation was not a triable issue in this case.

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Assignment

A party to a contract can assign her rights under the contract to a third-party, if the terms of the contract allow.

EXAMPLE

Yablonski v. Cawood, 1997

Yablonski assigned part of the annuity payments under his annuity contract to Cawood to repay a debt. Eventually, Yablonski went into bankruptcy adn a question cane before the courts concerning Yablonski's right to assign the benefits under the annuity contract. A collateral assignment will not change ownership. We will not be responsible for the validity of any assignment. We will not be bound by an assignment until written notice is recorded in our home office.

Yablonski contended that the annuity contract between the appellant and the Safeco made the assignment void and that the rights of unsecured creditors would be prejudicially affected by a finding that the assignment was valid. The Court concluded that "an equitable assignment as between assignee and assignor remains valid and enforceable, notwithstanding a 'non-assignability' clause in the original (annuity) contract."

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Expectation

Expectation is a basic principle of contract law that provides that the victim of a breach is entitled to be put in the same position he would have been had the contract been honoured.

EXAMPLE

Hirsch v. duBrule

In this case, a woman whose hair was prematurely thinning a $2,000 hair replacement system that did not work. The issue was whether a remedy was available to a dissatisfied purchaser in circumstances where the seller makes a pre-contract representation that is later expressly contradicted. The court found that the appropriate remedy in the case of innocent misrepresentation was to put the parties back in the position they would have been had the contract not been entered into (i.e. rescind the contract and refund the purchase price). However, it also found that in this case providing such a remedy would be unfair, as it did not take into account the attempts the sellers made to satisfy the purchaser's expectations. As such, the purchaser was entitled to the return of most, but not all, of her money.

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Duty to Mitigate

The principle of 'duty to mitigate' applies when a contract is breached. The victim of the breach has an obligation to take all reasonable steps to lessen the impact of the loss that arises as a result of the breach.

EXAMPLE

Coutts v. British Columbia

The case involved a court reporter (Coutts) whose employment was terminated and who receive severance amounting to 22 months' notice. At issue was whether the employer could deduct from its severance payments to Coutts any income Coutts earned over the notice period from his private court reporting business. The Court held that Coutts took proper steps to mitigate his income loss and that the income he earned from his private business should not be deducted from his settlement.

Specific Performance

Damages are normally payable to the plaintiff in cash and the defendant is not required to carry out the contract. However, in limited circumstances a plaintiff may be able to have the court force the defendant to fulfill a promise made under the contract.

EXAMPLE

Maisonneuve v. Delaurier, 2007

The Vendor and Purchaser entered into a Rent to Own Agreement that provided the Purchaser with an option to purchase the property at the end of a two-year period. The agreement contained provisions recognizing that the Purchaser was paying premium rent designed to save towards the purchase price. The Purchaser had delivered 12 post-dated rent cheques and continued extensive renovations to the property, and the Vendor subsequently relayed they no longer wanted to sell the property. The Purchaser sought an action for the specified performance for damages for breach of the agreement. The action was allowed and the specific performance was ordered.

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Injunctive Relief

An injunction is a court order requiring a party to refrain from taking a certain course of action (e.g. breaching a non-competition clause or entering a property). It is related to specific performance in that it compels a party to fulfill her duties under a contract, though in this case it is refraining from doing something rather than performing an act.

EXAMPLE

Allstate Insurance Company of Canada v. Larocque

This case involved a restrictive covenant in an employment contract. The insurance company employer applied for an injunction to prevent its former employee (larocque) from breaching restrictive covenants in his employment contract. Larocque's position was that because his employer had constructively dismissed him, he was no longer bound by his contract of employment. The Court did not grant the injunction.

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Income Tax Administration

The federal government administers the provincial and territorial individual income tax (except in Québec). An individual therefore files a single income tax return with the federal government. This return includes schedules specific to the taxpayer's place of residence, which is used to calculate and report the provincial or territorial income tax liability.

In filing an individual tax return, the individual is self-assessing the amount of tax that he or she owes. In reviewing the individual's return, the CRA could dispute the return and issue a reassessment. The individual could then object to the CRA's reassessment and ask the Tax Court to decide on the issue. The decision from the Tax Court could then be appealed to the Federal Court of Appeal, and its decision could possibly be appealed to the Supreme Court of Canada.

Residency

Relationship to Taxation

The issue of **residency** becomes an important consideration in the determining whether Canadian income taxes are payable by an individual. Generally, common law principles are the primary basis for determining if a person is a resident in Canada. A person can be considered a resident based on common law or case law principles that have evolved over the years and the decision is based upon specific facts of the situation.

In simple terms, individuals resident in Canada during a particular tax year are subject to income tax on their **worldwide income**. Conversely, individuals who are considered non-resident in Canada during a particular year are subject to income tax on income from predefined Canadian sources.

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The ITA does not define residence or resident. The leading case on this issue, *Thomson v. Minister of National Revenue*, was determined by the Supreme Court of Canada in 1946 and remains the precedent for Canadian residency.

The courts continue to view residence as a "matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question."[10]

Determining Country of Residence[11]

Determining a taxpayer's residency for tax purposes sounds like a simple question, and for many taxpayers there is no issue or question. In Canada, like many jurisdictions, residency is the major criterion used to establish income tax liability. An individual who is resident in Canada will be subject to Canadian income tax on his or her worldwide income, regardless of where that income is earned or generated. While non-residents may be subject to taxation in Canada, the type of income subject to tax is much narrower.

From the taxpayer's point of view, it may be desirable to be taxed in a country with a lower income tax liability. From Canada's point of view, however, tax revenue is gained or lost based on the taxpayer's determination of residency.

The CRA has published a folio[12] in which it sets out the criteria it uses when determining residency. The process followed by the CRA is to review a series of primary and secondary factors to establish whether an individual has residential ties to Canada

In order to achieve **non-resident status**, a taxpayer must sever all important residential ties to Canada.

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[10] Thomson v. Minister of National Revenue, 1946, Supreme Court of Canada, S.C.R. 209, page 225 http://www.canlii.org/en/ca/scc/doc/1946/1946canlii1/1946canlii1.html
[11] In what country Do I reside?, COMMENT, Edition 262, July/August 2010.
[12] S5-F1-C1 - Determining an Individual's Residence Status, November 24, 2015

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The **primary factors** used by the CRA to determine the issue of residency include (among other factors):

1. The dwelling place normally occupied by the taxpayer;
2. Where the taxpayer's spouse or common-law partner resides; and,
3. Where the taxpayer's dependents reside.

The dwelling an individual has maintained in Canada will play an important role in the evaluation. If the dwelling remains available to the taxpayer for his or her use, this is often viewed as a residential tie to Canada. On the other hand, leasing out the property (at market rates and terms) so that it is not available to the taxpayer can help break the residential ties.

Similarly, if the spouse and/or dependent children remain in Canada, that could be considered maintaining a residential tie to Canada. However, the CRA would take into consideration the relationship between the parties to determine whether they were living separate and apart already before the residency determination arose.

Even if the taxpayer is successful in establishing non-residency based on the above factors, the CRA looks at a group of **secondary factors** on a collective basis to determine whether the taxpayer is still a resident of Canada. It would be unusual for any one single factor to determine residency status, but evidence of several factors may tip the scale in the determination.

Secondary factors include:

1. Personal property in Canada (e.g. furniture, vehicle, etc.);
2. Social ties with Canada (e.g. membership in recreational organizations);
3. Economic ties with Canada (e.g. bank accounts, relationship with Canadian employer);
4. Landed immigrant status or appropriate work permits in Canada;
5. Hospitalization and medical insurance coverage from a province or territory of Canada;
6. Driver's license from a province or territory of Canada;
7. Vehicle registered in a province or territory of Canada;
8. A seasonal or leased dwelling place in Canada;
9. A Canadian passport; and,
10. Memberships in Canadian unions or professional organizations.

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This list is not intended to be exhaustive but rather is representative of the type of additional items considered by the CRA when assessing the issue of residency. The cumulative presence of several secondary ties could tip the scales in favour of a determination of tax residency. The weighting given to each will depend on the CRA's judgment in any set of circumstances. For example, a summer cottage that contains personal property, and to which the taxpayer returns every summer, will be two factors. The taxpayer who wants to break tax ties with Canada may want to close all Canadian bank accounts, cancel his or her driver's license, sell any automobiles, and cancel any golf memberships, to avoid the additional accumulation of secondary factors.

In Canada, a resident is taxed on his or her worldwide income. If a taxpayer wants to establish himself or herself as a non-resident of Canada, it is very important that he or she observe how the CRA will determine residency status, and ensure that all the primary factors and as many secondary factors as possible are avoided.

It is also important to note that non-residents may still be subject to Canadian taxation if they were employed in Canada, carried on business in Canada, or disposed of taxable Canadian property at any time in the year or in a previous year.

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Sojourning in Canada

The meaning of resident in Canada is extended by subsection 250(1) of the ITA to include any person who **sojourns** in Canada for a period of, or periods aggregating to, 183 days or more in a taxation year. The term sojourn means a short or brief stay. Effectively, individuals who visit Canada either on a single visit or a combination of visits and stay for a cumulative total of 183 days or more will be deemed resident in Canada for that taxation year and therefore subject to Canadian taxation on their worldwide income for that year.

The CRA counts a part day as a single day and, as noted above, aggregates the sum of all days from multiple visits throughout the year. While the 183 days sets a target number after which residency applies, it is important to note individuals could be deemed resident even if their visits total fewer than 183 days, simply because they present more permanent ties. The 183-day criterion typically applies to temporary situations, while more permanent situations do not generally fall into this deeming provision but are assessed on the degree to which they are ordinarily resident.

Part-Time Resident

Individuals immigrating to or emigrating from Canada are typically assessed as **part-time residents** of Canada for the year in which they arrive or depart. Section 114 of the ITA provides that individuals who immigrate and become residents of Canada are subject to a part-time residence status in the year they arrive. The point in time when they arrive creates a **"fresh start"** and is the point from which residency is measured for the taxation year.

Similarly, individuals who emigrate and cease to be residents of Canada are considered part-time residents for the year of departure. The point at which individuals make a **"clean break"** is the time at which they are no longer considered a resident. For tax purposes, emigrating individuals are considered a Canadian resident up to the point of the clean break.

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The period during which the person was resident in Canada constitutes the taxpayer's taxation year for the computation of taxes payable in Canada during the year. To determine a part-time residence, you must look at the facts of the situation and establish a point in time at which either a "clean break" or a "fresh start" occurred in respect to the individual's residency in Canada. Examples of evidence of a clean break include:

- The individual leaves Canada;
- The individual's spouse or common-law partner and dependents leave Canada;
- The individual is immigrating to a new country (or becomes a resident of that country).

CRA Assessment

The Canadian tax system is based on a self-assessment or honour system, requiring every taxpayer to file an annual income tax return with the CRA, which sets out income earned, eligible expenses, deductions and credits. The CRA does an initial review, taking into account items such as the taxpayer's filing history, relevant tax information filed in the current return, and systematic red flags such as risk assessment checks.

Notice of Assessment

The CRA's initial communication with the taxpayer after having received the income tax filing is a notice of assessment. A **notice of assessment** is the document the CRA sends to taxpayers after reviewing and assessing their income tax return submitted for a particular tax year. In the notice of assessment, the CRA confirms or adjusts the taxpayer's filing position and recalculates the income tax liability. A refund is provided if the assessment results in less tax payable relative to the amount already paid for the year.

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The CRA could challenge the return and demand payment of the difference between what the taxpayer has already paid and what CRA has determined in its recalculation. In challenging the tax return, the CRA will set out their reasoning for determining a different income tax liability. Another outcome is for the CRA to request more information to substantiate an element of the taxpayer's return.

When the CRA requests additional information in their notice of assessment, the taxpayer has 90 days to provide such information. If the CRA's notice of assessment objects to an element of the taxpayer's annual filing, the taxpayer has 90 days to file a notice of objection.

Notice of Reassessment

The CRA has the authority to reassess a taxpayer either on its own initiative or at the request of the taxpayer. The CRA may reassess up to three years after the mailing of the original notice of assessment (four years for a mutual fund trust or a corporation that is not a Canadian-controlled private corporation). A taxpayer may request a change to a return for any year ending in the previous 10 years. In 2019, taxpayers may request a change to any of their 2009 to 2018 returns.

A **reassessment** initiated by the CRA may arise when the CRA has taken a further look at a taxpayer's return or other information has arisen. For example, the CRA matches the income claimed by a taxpayer with the T-slips filed by employers and financial institutions. Should the CRA note a discrepancy, either in the amount reported or a situation where income has not been self-reported, the CRA will issue a notice of reassessment to adjust the discrepancy. The evolution of technology has enhanced the CRA's ability to identify non-compliance in a wide-variety of areas through in-depth statistical analysis.

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Helpful Information

The notice of assessment (or reassessment) provides the planner with important tax information that is helpful when dealing with client-specific circumstances. For example, the notice of assessment includes:

- **RRSP deduction limit:** This will help when confirming the client's deduction limit when assessing the value of any RRSP room available.
- **Unused RRSP contributions:** The notice confirms RRSP amounts that have been contributed but not yet deducted.
- **Unused capital losses from other years:** These are capital losses that arose in prior years that have not yet been used to offset capital gains.

Advisors dealing in these areas often find it helpful to have clients provide copies of the most recent notice of assessment as a validating tool.

Appeals

Canada Revenue Agency

Upon receiving an assessment or reassessment, taxpayers have several options. The taxpayer could simply agree with the CRA's recalculation and pay the outstanding amount, which could include taxes, interest and penalties. Taxpayers may speak informally with CRA officials in order to acquire more information that could help to reconcile the difference between their original filing position and the CRA's most recent calculations.

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More formally, the taxpayer could file a **notice of objection.** This is a formal written statement that the taxpayer sends to the CRA to record his or her disagreement with the CRA's position. There are very strict time limits by which a taxpayer may file an objection to the notice of assessment or reassessment. Consulting a tax professional is recommended in these circumstances.

The CRA will make a decision in respect of the taxpayer's objection and will send a written response. The decision will confirm, vary, or vacate the disputed assessment.

Tax Court of Canada

A negative decision by the CRA with respect to the taxpayer's notice of objection may be appealed to the **Tax Court of Canada (TCC)**. The Tax Court offers two types of procedures:

- **Informal:** Informal procedure provides less rigidity when applying the rules of evidence and decisions do not create precedents. Individual taxpayers may represent themselves or be represented by another individual. This appeal procedure is available when federal taxes and penalties owing do not exceed $25,000 (excludes interest owing). For amounts greater than $25,000, taxpayers may choose this process if they limit the amount under appeal to $25,000. Decisions through this procedure typically cannot be appealed to a higher-level court.
- **General Procedure:** This is the default level of hearing unless the informal procedure is selected. Rules for evidence and procedures follow formal standards. Individual taxpayers may represent themselves or be represented by another individual. In the case of corporations, generally they must be represented by a lawyer, unless the court makes a special concession to allow a corporate director to represent the company. The taxpayer could be assessed court costs and outcomes can create precedents.

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Federal Court of Appeal

A decision by the Tax Court of Canada (general procedure) can be appealed to the **Federal Court of Appeal (FCA).**

Supreme Court of Canada

Either the crown or the taxpayer may apply to the **Supreme Court of Canada (SCC)** for leave (permission) to appeal a decision coming out of the FCA. The SCC is the highest court in Canada and, as such, is the court of last resort. The nature of the SCC is a general court of appeal, which means it can hear all types of cases, including tax cases.

An application to the SCC is reviewed by three judges who decide if the case is to proceed to the SCC. The standard considered when assessing a leave to appeal is whether the issue before the court is of public importance and of interest to Canadians. "Leave to appeal is granted by the Court if the case involves a question of public importance or if it raises an important issue of law (or an issue of both law and fact) that warrants consideration by the Court. The Court's decision whether to grant leave to appeal is based on its assessment of the public importance of the legal issues raised in the case in question."[13]

[13] http://www.scc-csc.ca/

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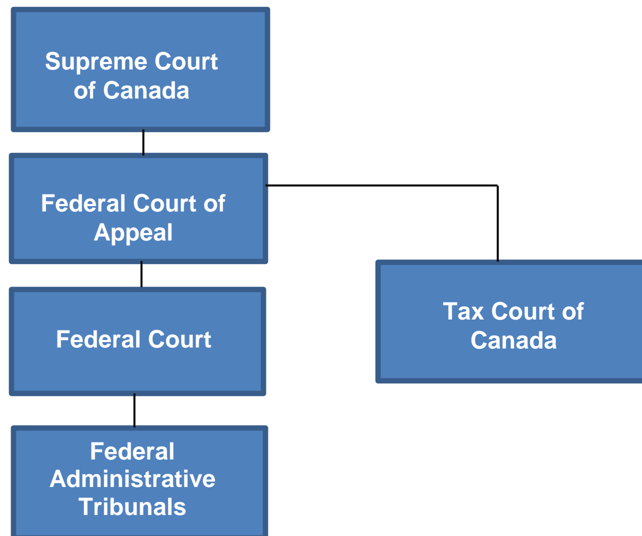

General Anti-Avoidance Rule[14]

The **General Anti-Avoidance Rule (GAAR)**, defined in section 245 of the ITA, was introduced in 1988. It is intended to prevent abusive tax avoidance transactions and applies after the application of more specific anti-avoidance provisions in the ITA.

Since that time, these rules have generated many court cases. Some cases were dealt with before they reached the courts, some were settled at the Tax Court level, some were appealed to the Federal Court of Appeal, and a few cases made it to the Supreme Court of Canada. The Supreme Court has set out three criteria that must exist for GAAR to be applied:

1. The taxpayer must realize a tax benefit;
2. The transaction must have been arranged primarily for the tax benefit and not for bona fide purposes; and,
3. The transaction must be abusive tax avoidance, (i.e. it is not within the object, spirit, or purpose of the ITA provisions relied upon by the taxpayer).

[14] Adapted from Comment, Edition 265, January/February 2011.

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The burden is on the taxpayer to refute points (1) and (2), and on the CRA to establish point (3). In applying GAAR, it is not simply the single transaction that is scrutinized but rather any series of transactions that include the offensive transaction.

GAAR is applied only in situations that have been approved by the GAAR Committee. The GAAR Committee is comprised of senior officials at the CRA as well as senior officials from the federal departments of Justice and Finance. If the tax assessor feels that GAAR may apply, he or she submits the file to the GAAR Committee. This group will then review the file and determine whether the CRA should apply GAAR to the taxpayer's situation.

GAAR is the CRA's biggest stick in dealing with creative tax planners. Tax planners who are aware of the CRA's concerns and of the Court's criteria, as it relates to the application of GAAR, are invaluable in developing appropriate strategies for their clients.

Since inception until the 2017-2018 fiscal year, the GAAR Committee has reviewed 1,472 cases and applied GAAR to approximately three out of every four files presented. There are no current statistics to indicate how many of these total cases reviewed proceeded to litigation. The most recent statistic, from 2013 data, indicates 54 out of 897 cases to which the Committee applied GAAR proceeded to court and the CRA was successful on 28 cases, or about half of the time.

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Voluntary Disclosure

Like many countries around the world, Canada utilizes a **Voluntary Disclosure Program (VDP)** designed to encourage the disclosure of information previously not reported or to correct incomplete or inaccurate information as it relates to income and excise tax. Effectively, the program provides individuals, trusts, partnerships, and corporations with a one-time opportunity to come clean about unreported income, under-reported income, or perhaps administrative filings that have been overlooked. The incentive for taxpayers is that, depending on the circumstances, the CRA may have discretionary authority to waive or cancel all or a portion of interest or penalties that would otherwise be payable under the ITA along with the opportunity to avoid prosecution.

The VDP is an administrative program, not a legislated program. The CRA's authority to offer relief from interest and penalties for up to 10 years is embedded in subsection 220(3.1) of the ITA.

Disclosure Requirements

A disclosure by a taxpayer must meet specific conditions in order to be valid, which can be summarized in general terms as:

- **Voluntary:** It must be completely voluntary and not in response to an audit or enforcement action already initiated by the CRA.
- **Complete:** The taxpayer must provide complete and accurate information within the required time frames.
- **Financial penalty:** There must be a financial penalty or potential penalty associated with the disclosure.
- **Timing of indiscretion:** The time period to which the disclosure applies must be at least one year old.
- **Payment:** Payment of the estimated taxes owing must be included with the application. The CRA may consider payment arrangements depending on the circumstances.

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Two Streams

The CRA classifies the voluntary disclosure applications into two different streams.

Limited Program – Taxpayers who disclose a non-compliance indiscretion that involves an element of intentional conduct will be considered under the limited program stream. The benefit arising under this stream is that the CRA agrees not to pursue criminal prosecution or to charge gross negligence penalties, although the taxpayer will be subject to interest and penalties. Taxpayers are required to sign a waiver under which they release their right to object and appeal the resulting assessment.

General Stream – Most cases that do fall with the limited stream are assessed under the general stream. These taxpayers are eligible for penalty relief and partial interest relief.

Limited Availability

In most situations, taxpayers are eligible for only one voluntary disclosure. On occasion, a second application may be considered when the circumstances surrounding the second application are in respect of a different matter than the original disclosure and the circumstances are beyond the taxpayer's control.

Understanding the Implications

The concept of a voluntary disclosure makes good sense because it provides taxpayers with the opportunity to clear up a past indiscretion; however, the seriousness should not be understated. Taxpayers should be encouraged to consult a lawyer to discuss the options and to manage the process. There is an element of uncertainty associated with making a voluntary disclosure that can arise at several stages of the process.

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If, for example, the CRA has already initiated an enforcement action against the taxpayer, the disclosure may not be accepted. Alternatively, if the CRA views the information as incomplete, the disclosure could be denied. There are circumstances where information presented in a voluntary disclosure application would be used against the taxpayer in situations where the application has been denied. A voluntary disclosure application is not addressed through the Tax Court; instead, it falls within the authority of administrative law, which can be complex and require legal guidance.

Tax Shelters

The term **tax shelter** is defined within the ITA and in simple terms, is a gifting arrangement or acquisition of property that is presented in a way that the purchaser or donor derives benefits from the arrangement that typically exceed the net cost of entering the arrangement. While the federal government would ideally like to regulate tax shelters, they are limited because these arrangements fall within the scope of provincial jurisdiction. Therefore, the federal government has resorted to the use of tax shelter identification numbers to track the schemes and participants.

The promoter of any arrangement that meets the definition of a tax shelter must apply for and utilize an identification number before undertaking any activity. The CRA uses the information to track and develop audits associated with activities undertaken by the shelter or shelter participants. Recent administrative changes at the CRA have resulted in claims by taxpayers for donation shelters being withheld by the CRA until after an audit of the tax shelter.

Tax shelters are discussed further in Module 4.

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Third-Party Civil Penalties

The concept of **third-party civil penalties** arose in 2000 as a means by which to deter third parties from promoting omissions or false statements with respect to income tax and GST/HST. The penalty applies where a person who "makes or furnishes, participates in the making of, or causes another person to make or furnish a statement that the person knows or should know is a false statement that could be used by another person." Cases where a tax auditor recommends penalties to a taxpayer's advisors are sent to the **Third-Party Penalty Review Committee** comprised of senior representatives from the CRA, Department of Finance, and Department of Justice.

The advisor penalty is equal to the greater of:

- $1,000; and
  - The total amount the person making the false statement is entitled to receive for a planning activity or a valuation activity.

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Summary

After completing this module you should have gained a solid understanding of:

- The structure of the federal and provincial legal systems and how each jurisdiction influences financial and estate planning;
- The structure of the income tax system and the protocols for developing and administering the Canadian tax system including the consequences of violating tax laws;
- The legal requirements for the development and operation of contracts.

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Module 2: Taxation of Life Insurance & Living Benefits

Learning Objectives

Upon completion of this module, you should be able to:

- Apply advanced concepts related to the taxation of life insurance policies in client-specific situations;
- Synthesize the tax consequences in respect of annuities, mutual funds and segregated funds as they relate to wealth preservation and estate objectives;
- Evaluate and synthesize client situations in respect of the tax treatment of living benefits insurance.

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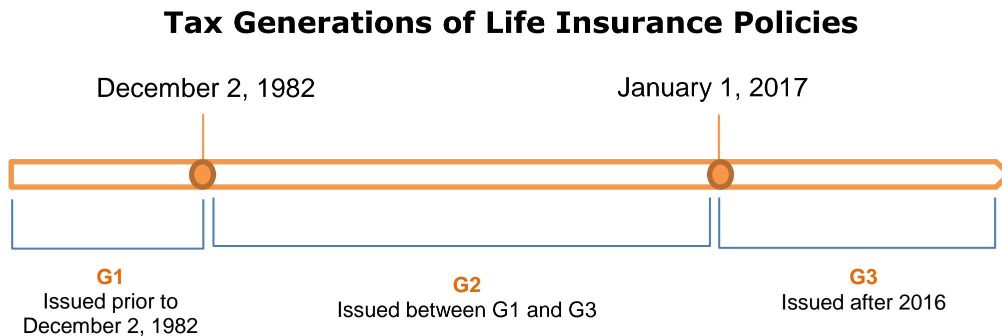
Life Insurance

The rules related to the taxation of life insurance policies have evolved over time. There are currently three different tax regimes that could apply to a life insurance policy depending upon the generation of the policy. The following three designations will be used throughout this material to differentiate between these three unique generations of life insurance policies for tax purposes. The distinction is very important because policy taxation will be based on when the policy was issued, last acquired, or failed to be grandfathered under an older set of rules.

Tax Generations of Life Insurance Policies



- The term G1 is used to refer to policies issued prior to December 2, 1982;
- The term G3 refers to policies issued after 2016; and,
- The term G2 refers to policies issued between G1 and G3.

Exempt versus Non-Exempt

Prior to 1982, there was no limit on the amount of income that could accrue tax-deferred within a life insurance policy (other than annuity contracts). If the policy was in-force on the death of the life insured under the contract, all accrued and unreported income could be paid out tax-free to the named beneficiaries by way of a death benefit. Throughout the duration of the policy, there was no restriction on how much premium could be deposited to generate tax-deferred income growth inside the cash value of the contract.

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New rules were enacted effective December 2, 1982, restricting the tax-free investment growth. The 1982 changes introduced the concept of exempt and non-exempt.

Exempt or non-exempt status of a life insurance policy is used to distinguish between life insurance policies in which emphasis is on benefits at death **(exempt)** and those that offer the potential for significant lifetime "investment" benefits **(non-exempt)**.

Non-Exempt

A non-exempt policy is subject to annual accrual tax reporting. The policyholder would include in income the amount of the policy's accumulating fund in excess of the adjusted cost basis on the policy on an annual basis.

Exempt Test Policy

An **Exempt Test Policy (ETP)** is a notional life insurance policy deemed to exist only for the purposes of the exemption test. The ETP policy is used as a benchmark against which the actual policy is measured – the accumulating fund of the ETP is the maximum limit that the accumulating fund of the corresponding real or actual policy can reach without failing the exemption test. The initial ETP is deemed to come into effect on the day the actual policy is issued. A new ETP is established for each new layer of coverage added to the actual policy.

If the accumulating fund of the policy is in excess of the accumulating fund of the ETP, then the policy is considered to be a non-exempt policy subject to annual accrual taxation from that date forward. If the policy fails the exemption test and is not corrected within 60 days, it is considered non-exempt from that date forward without any ability to be exempt thereafter.

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G2 & G3 Policies

The ETP is the same regardless of the type of policy being purchased.

- **For G2 policies:** The ETP is a 20-pay endowment at the later of 10 years after the date of issue and age 85 of the life insured.
- **For G3 policies:** The ETP will be an 8-pay endowment at age 90. Being an endowment-type product, the ETP will have an accumulating fund at maturity equal to the benefit on death under the policy.

For G2 policies, the accumulating fund value of the ETP is generally based on the mortality and interest rates used by the insurer in determining the premiums for the actual policy. The minimum rate of interest used for the ETP is 3 percent for policies issued before May 1, 1985, and 4 percent for policies issued after April 30, 1985.

For G3 policies, the accumulating fund of the ETP uses the Canadian Institute of Actuaries 1986–1992 mortality tables and an interest rate of 3.5 percent. This is designed to better reflect mortality rates and investment returns while improving consistency between the measurement of the savings in an actual policy and the measurement of the savings in the ETP.

Monitoring of Exemption Test

All exempt life insurance policies are tested on each policy anniversary. To be exempt, the policy must meet the test both at that time (current test) and on each projected anniversary thereafter (pretest) based on reasonable assumptions for all pertinent factors.

To be exempt, the policy's accumulating fund (determined without regard to any policy loan) must not exceed, at any policy anniversary, the sum of the accumulating funds of all ETPs issued. The test does not require a minimum number of premium payments.

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The test is normally based on the total benefit on death under the actual policy, including term insurance riders. However, the ITA provides that the following riders for additional life insurance (other than an accidental death benefit) be treated as separate policies, each with its own accumulating fund, ETP, and exemption test:

- A rider added after December 1, 1982, to a life insurance policy (other than an annuity contract) last acquired before December 2, 1982. This provision prevents the sheltering of additional investments in grandfathered policies.
- A rider added after 1989 to a non-exempt life insurance policy (other than an annuity contract) last acquired before 1990. This provision ensures that accrued income under the rider is taxed annually even though the original policy may be subject to triennial accrual taxation.

Paid-Up Additions

For the purposes of the exemption test, paid-up additions are part of the policy. As paid-up additions have a high ratio of cash value relative to the additional amount insured, this could make the policy non-exempt. Where a pretest reveals that the policy will become non-exempt through paid-up additions based on the current dividend scale, another dividend option must be chosen to keep the policy exempt.

The accumulating fund of the ETP is calculated as of the end of a policy year. In order to use comparable values for the actual policy, dividends payable on a policy anniversary are taken into the calculation where applicable, such as in the case of paid-up additions. On the other hand, the premium payable on a policy anniversary is treated as though it were payable on the following day.

Should a policy fail an exemption test, there is a 60-day period from the end of the policy year during which the policy can be restored to exempt status (Regulation 306(4)(d)). Failure to restore the policy's exempt status means that policy will be non-exempt from then onwards with no further opportunity to restore exempt status.

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Grandfathering of G1 Policies

The grandfathering rules recognize the value of the preferred tax treatment afforded to life insurance policies issued before the introduction of the G2 rules, and allows for the continuation of this treatment for policies last acquired before December 2, 1982. These rules also seek to prevent tax avoidance when policyholders make funding changes that produce substantial increases in the accumulating fund of these policies.

The two key concepts for these rules are prescribed premiums and prescribed increases in death benefits. If a policy owner triggers both a prescribed premium and prescribed increased in death benefit, it causes the loss of G1 grandfathered status.

Prescribed Premium

A premium paid under a life insurance policy is considered prescribed if the amount paid exceeds the amount as scheduled under the policy (which would have been fixed and determined before December 2, 1982). However, if the scheduled premium is adjusted in any of the following circumstances and the premium increases as a result, the new premiums will not be considered **prescribed premiums**:

- A change in underwriting class;
- A change in the frequency of premium payments;
- An addition or deletion of waiver of premium, disability income, accidental death, or guaranteed insurability riders;
- Premium adjustments on a class basis (not under a conversion privilege) for changes in interest, mortality, and expenses, or for changes in the benefit on death relating to increases in the Consumer Price Index (CPI) under the policy's terms as they read on December 1, 1982;
- The purchase of an additional death benefit under a participating policy with policy dividends or with interest earned on policy dividends left on deposit with the insurer;

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- Re-dating lapsed policies not later than 60 days after the end of the calendar year in which the lapse occurred, or re-dating to eliminate policy loans;
- Premium increases due to a correction of erroneous information in the application;
- Late payment of premiums or early payment no more than 30 days before the due date;
- Policy loan interest that qualifies as a premium.

Generally, for a prescribed premium to remain as such after adjustments, the increase must result from changes to higher premium plans, policy increases, and optional or unscheduled deposits.

Prescribed Increase in Death Benefits

A **prescribed increase in a death benefit** under a life insurance policy occurs where the benefit on death exceeds the benefit on death as was fixed and determined before December 2, 1982.

However, if the fixed benefit is adjusted in any of the following circumstances and the benefit increases as a result, the increase will not be considered a prescribed increase:

- The purchase of an additional benefit on death under a participating policy with policy dividends or interest earned on policy dividends left on deposit with the insurer;
- An increase on a class basis for changes in interest, mortality, and expenses, or increases in the CPI under the policy's terms as they read on December 1, 1982;
- An increase as a result of prepaid premiums, provided that it does not exceed the aggregate of the premiums that would otherwise have been paid and that they would not have been prescribed premiums;

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- An increase that is not attributable (in any part) to a prescribed premium paid or to interest earned on such a premium where the benefit on death for the policy is a specific mathematical function of factors, including the policy's cash surrender value, or CSV (such as in some universal life policies), and that function has not changed since December 1, 1982;
- An increase granted by the life insurer on a class basis without consideration that is not pursuant to any term of the contract.

An additional accidental death benefit is not considered to be a benefit on death for this purpose. This means the policy owner could not convert an accidental death benefit into a regular death benefit and retain grandfathering status.

Further, any new rider providing for additional life insurance (other than an accidental death benefit) is deemed to be a separate policy. As a result, a prescribed increase in a benefit on death occurs only when the face amount of the basic policy is increased and the increase was not fixed before December 2, 1982 (i.e. an increase through a policy change applied for by the policy owner).

Last Acquired

One factor critical to determining whether a life insurance policy is exempt and whether it is subject to the post-December 1, 1982 tax rules (G2) or post-2016 rules (G3) is the date on which the policy was last acquired. For tax purposes, a policy can be acquired a number of times during its lifetime, sometimes without ceasing to be the lawful property of the current policy owner.

When a life insurance policy is issued to its first owner, it is deemed to have been acquired on the later of:

- The date the policy came into force;
- The date the application signed by the policy owner, was filed with the insurer, the insurer's agent, or the insurer's branch office.

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Transfer of Ownership

When ownership of a life insurance policy is subsequently transferred, the new owner will be considered to have acquired the policy on the date of transfer. However, in a non-arm's-length transfer of a policy last acquired before December 2, 1982, the policy retains the status of being last acquired before December 2, 1982.

Exercise of a Contractual Right

The date on which a life insurance policy was last acquired does not change for a G2 policy where the policyholder exercises a contractual right under the policy (e.g. where term insurance is renewed or converted). However, where the policyholder elects to take the CSV of a policy that was last acquired after December 1, 1982, in the form of an annuity under the policy's settlement options, the policyholder becomes the owner of a new contract and is deemed to have acquired that contract at the time of the annuitization.

EXAMPLE

Louisa owns a whole life insurance policy that was last acquired in 1985. The policy has a CSV of $28,200 and an adjusted cost basis (ACB) of $8,100. As she no longer has any use for the policy's death benefit, Louisa will surrender the policy by exercising her contractual right to convert its CSV to a life annuity.

Since Louisa's policy was last acquired after December 1, 1982, the annuitization of the CSV constitutes a disposition of the policy for tax purposes, and the $20,100 policy gain must be reported as income to Louisa in the year of annuitization. The ACB of the annuity then becomes $28,200 (equal to the ACB of $8,100 plus the policy gain $20,100).

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If the policy had been last acquired before December 2, 1982, the conversion to an annuity would not be a disposition for tax purposes. Louisa would have no policy gain to report as a consequence of the conversion and the ACB of the annuity would be $8,100 (the same ACB as the policy that was converted to the annuity). Further, the $20,100 policy would gain in the contract at the same time of annuitization of the CSV ($28,200-$8,100=$20,100) would be reported over the lifetime of the annuity as received.

Policy Reinstatement

A policy reinstated more than 60 days after the end of the calendar year in which a lapse occurs is deemed to have been last acquired on the date of reinstatement.

EXAMPLE

Jose purchased a term to 100 policy in July of 1982. In November 2013, Jose was unable to pay his annual premium and the policy lapsed. He reinstated the policy in June 2014. Because the policy was reinstated more than 60 days after the end of the calendar year (2013) in which the lapse occurred, the policy was deemed to have been lat acquired on the reinstatement date of June 2014. As such, this policy became a post-December 1, 1982 contract and is subject to the G2 tax regime.

Other Policy Changes

The tax treatment of policy changes other than those listed in this section remains uncertain. The ITA does not provide a blanket exemption from disposition where the policy contains only a very general provision allowing for material changes.

Rather, any allowable changes (i.e. changes that would not result in a deemed disposition) must be set out in the policy such that no negotiation or renegotiation of the policy would be required at the time the change occurs.

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Rules

A life insurance policy with fixed benefits and fixed premiums last acquired before December 2, 1982, is taxed under the old rules as long as it remains unchanged. Beneficiary changes, collateral assignments, and adjustments that meet the definitions of prescribed premium or prescribed increase in death benefit are not considered changes for the purpose of this rule.

A life insurance policy issued under a conversion privilege provided under the terms of the original policy as it read on December 1, 1982 (including a term insurance rider), is deemed to be a continuation of the original policy. Any premium increase is considered a prescribed premium.

If dividends are used after December 1, 1982, to purchase an additional benefit on death (i.e. term additions) and such benefit is later converted, that part of the policy is deemed to be a separate life insurance policy issued at the time of the conversion.

On a transfer of ownership at arm's length, the policy is acquired on the date of transfer and the G2 or G3 rules will apply.

If the transfer is not at arm's length, a life insurance policy last acquired before December 2, 1982, retains that status and continues to be taxed under the old rules. This rule applies to transfers with or without consideration in taxation years commencing after 1982.

Where a policy is changed or unscheduled premiums are paid, the rules can be summarized as follows:

- A life insurance policy (other than an annuity contract) last acquired before December 2, 1982, will become subject to taxation under the G2 or G3 rules if:
  - A prescribed premium has been paid; and,
  - The policy is not an exempt policy or there has been a prescribed increase in a benefit on death.

These two conditions can occur at different times, in which case the policy continues to be subject to the old rules until the second condition occurs.

The examples in the following section illustrate the application of the above rules in several situations as they relate to the grandfathering of G1 policies.

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Rule #1

Fixed premium, prescribed increase in death benefit:

a. Change from endowment to whole life, continuing with the same premium but increasing the amount of insurance.

- The old rules apply. If the policy is later annuitized, the treatment will be the same as in rule 8.

Rule #2

Prescribed premium, no change in death benefit and the policy passes exemption test:

a. Term conversion to whole life using attained age.

- The old rules apply.
- If at a later date, a prescribed increase occurs or the policy fails the exemption test, the new rules will apply at that time.
- If the old rules apply and the policy is later annuitized before the death of the life insured, there is no taxation on annuitization.

b. Term conversion to whole life backdated to an earlier age.

- See the 250 percent test. If the policy passes that test, the old rules apply.
- If it fails, the issue date of the exemption test policy is changed.
- If the policy then passes the exemption test, the old rules apply; otherwise, the new rules apply.

Rule #3

No premium increase, no change in death benefit, but the policy fails the exempt test:

a. Term conversion to 10-year endowment.

- The new rules apply.

b. Change of whole life to 10-year endowment.

- The new rules apply. There is no deemed disposition at the time of the change. The policy will be subject to accrual taxation and all accrued income will be taxed at the next accrual date.

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Rule #4

Prescribed premium, increase in the death benefit:

a. Change $50,000 WL to $100,000 WL or 10-year endowment.

- The new rules apply. If the new policy is exempt, there will be no deemed disposition. If the policy ceases to be exempt, there will be a deemed disposition for proceeds equal to the accumulating fund. In this deemed disposition, all accrued income will be taxed.

Rule #5

Addition of a policy rider with no change in basic policy:

- The old rules apply to the basic policy. The rider is deemed to be a separate policy and the new rules apply.

Rule #6

Transfer of ownership:

a. Sale at arm's length.

- The policy gain is taxed at the time of transfer and the new rules apply thereafter to the new owner of the policy.

b. Policy on husband's life gifted by husband to wife.

- For transfers before 1990, the policy gain was taxed at the time of transfer. Transfers after 1989 are treated as rollovers unless disposition at CSV is elected. The old rules continue to apply to the new owner of the policy.

c. Policy on child's life gifted by husband to wife.

- There is no taxation at the time of transfer. The old rules continue to apply.

Rule #7

Fixed premium, reduction in a benefit on death:

a. Change whole life to endowment reducing the face amount but keeping the premium unchanged.

- The old rules apply.

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Rule #8

Conversion into an annuity contract under the settlement options of the policy before the death of the life insured:

- Under subsection 148(6), which applies only to policies last acquired before December 2, 1982, the conversion is deemed not to be a disposition. The annuity is not subject to accrual taxation.

Exemption Test for G3 Policies

The following exemption test rules apply for policies issued after 2016.

- The accumulating fund of the actual policy and the exemption test policy is determined by using the Canadian Institute of Actuaries 1986–1992 mortality tables and an interest rate of 3.5 percent. These are changes introduced for use after 2016 to better reflect mortality rates and investment returns while improving consistency between the measurement of the savings in an actual policy and the measurement of the savings in the exemption test policy.
- The endowment period of the exemption test policy is now set at age 90. Prior to 2017 it was set at age 85, but was increased to reflect longer life expectancy.
- The savings in an actual policy is measured using the greater of the cash surrender value of the policy (before the application of surrender charges) and the "net premium reserve" (to be defined) in respect of the policy. The intent is to capture all savings in an actual policy while providing consistency between the measurement of the savings in the policy and the measurement of the savings in the exemption test policy.
- The pay period of the exemption test policy is now set at eight years. Prior to 2017, it was set at 20 years. The change was made to better reflect industry practices and the pay period used in other countries.

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Adjusted Cost Basis of G2 Life Insurance Policy

A policy owner's **adjusted cost basis (ACB)** of an interest in a life insurance policy is the base value from which accrued income and policy gains are measured. It follows that a higher ACB is generally more beneficial to the policyholder than a lower one when determining the amount subject to taxation in respect of a disposition of an interest in the contract.

EXAMPLE

Werner owns three $50,000 face amount whole life insurance policies purchased at different times from different life insurance companies.

Policy A has been in force for 12 years and has a CSV of $12,000 and an ACB of $7,200.

Policy B has been in force for 16 years and has a CSV of $12,000 and an ACB of $6,100.

Policy C has been in force for 8 years and has a CSV of $12,000 and an ACB of $13,000.

If Werner surrenders all of the policies today, he will have to report taxable policy gains on the dispositions A and B and nothing in respect of C, as summarized below.

Policy	CSV	ACB	Gain
A	$12,000	$7,200	$4,800
B	$12,000	$6,100	$5,900
C	$12,000	$13,000	none

Given that each of these policies has the same CSV, the policy with the highest ACB (policy C) has the lowest taxable policy gain (nil) on disposition.

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Corporate-Owned Insurance Policies

An exception to this rule occurs at the death of a life insured under a policy payable to a private corporation. In this instance, a lower ACB is more beneficial because the credit to the company's capital dividend account is calculated as the death benefit received less the policy's ACB. If the entire death benefit were paid to the shareholders, there would be two dividends - a capital dividend and a taxable dividend, which would be equal to the ACB of the contract.

EXAMPLE

Assume that the policies owned by Werner were instead owned by and payable to his private corporation and the policy insured the life of a key employee. Assume Werner is the sole shareholder of the corporation so any dividends paid from the corporation are payable to Werner (taxable and capital dividends). On the death of the key employee, the policy benefit would be paid to the corporation and the credit to the company's capital dividend account would be as follows:

Policy	Death Benefit	ACB	Capital Dividend	Taxable Dividend
A	$50,000	$7,200	$42,800	$7,200
B	$50,000	$6,100	$43,900	$6,100
C	$50,000	$13,000	$37,000	$13,000

In this case, Policy B, which has the lowest ACB, offers the most advantageous results. Note that if Werner's company were to surrender the policies during the lifetime of the key employee, Policy C, with the higher ACB, would yield the greatest after-tax advantage for the corporation.

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Adjusted Cost Basis (ACB)

The adjusted cost basis (ACB) changes with each transaction in respect of the policy. Some transactions increase the ACB and some reduce it. The ACB is the sum of the amounts of each component that increases ACB less the sum of each component that reduces ACB.

Increases to the ACB

Some of the factors that **increase the ACB** of a G2 and G3 policy are:

1. The cost of all interests in the policy acquired by absolute assignment and the deemed cost of all interests in the policy acquired by a new owner following the death of the previous owner.

EXAMPLE

Ralph and his partner Dwayne, have whole life insurance policies on each other's life to help fund a business buy/sell agreement in the event of either of their deaths or retirement. They decide to dissolve their business venture and "swap" policies by way of absolute assignments. At the time of the swap, Ralph's policy on Dwayne's life has a CSV of $12,000 and an ACB of $4,200. Ralph is deemed to dispose of the policy for proceeds equal to its CSV and must report $7,800 ($12,000 – $4,200 = $7,800) of policy gain. Dwayne receives the policy with an ACB equal to Ralph's deemed proceeds of $12,000. The same result would have occurred had Ralph (the policy owner) died and named Dwayne as successor owner under the contract.

2. Premiums paid by the policyholder or on the policyholder's behalf.

EXAMPLE (CONT'D)

Each year that Ralph pays the $820 premium of the policy on Dwayne's life, the ACB of the policy is increased by $820.

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3. Policy gains required to be included in income (e.g. from dividends or policy loans).

EXAMPLE (CONT'D)

The policy on Dwayne's life has a CSV of $12,000 and an ACB of $4,200. Any portion of a policy loan in excess of the policy's ACB is reported to the policy owner as taxable income (policy gain). If Ralph borrows $5,000 against the policy instead of transferring it to Dwayne, he will receive the first $4,200 of the loan (equal to the ACB of the policy) tax-free and report the other $800 as taxable policy gain. The ACB will be reduced by the policy loan of $5,000, but the reporting of the $800 gain would add $800 to the ACB of the policy. The net adjustment would be $4,200, resulting in a nil ACB.

4. Income reported under non-exempt policies.
5. Certain policy loan repayments.

EXAMPLE (CONT'D)

When Ralph borrowed $5,000 against the policy on Dwayne's life, the ACB was reduced to nil (from $4,200) by the first $4,200 of the loan, which was received by Ralph tax-free. The ACB was then increased from negative $800 to nil when the balance of the loan ($800) was reported as taxable policy gain in Ralph's hands.

If Ralph were to repay $2,000 of the loan (assuming no other transactions), the repayment increases the net CSV of the policy and adds $2,000 to the ACB of the policy, increasing it from nil to $2,000.

The repayment also qualifies for a tax deduction for Ralph; the lesser of any gain previously reported and the amount of the repayment, i.e. lesser of $800 and $2,000. The deduction of $800 will reduce Ralph's ACB by $800 to $1,200.

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Decreases to the ACB

Some of the factors that reduce the ACB of a G2 and G3 policy are:

1. Proceeds of the disposition of an interest in the policy, including loans taken after March 31, 1978.

> **EXAMPLE (CONT'D)**
>
> Taking out a tax-free policy loan up to the ACB of the policy on Dwayne's life results in a reduction of the policy ACB (and its net CSV) by $4,200 (equal to the ACB of the policy).

2. The amount of any policy loan that was outstanding on March 31, 1978.
3. The Net Cost of Pure Insurance (NCPI) determined immediately before the end of each calendar year ending in a taxation year commencing after May 31, 1985.

   The NCPI is meant to represent the "cost" of the insurance coverage under the policy. The NCPI is calculated by the insurer as prescribed under Regulation 308(1) for the year of purchase (using a full year's NCPI) and each subsequent year, except the year of death or surrender. It is calculated by multiplying the net amount at risk for the year by mortality rates based on the CIA 1969–75 Select and Ultimate Mortality Table for G2 and the CIA 1986-1992 table for G3.

For G2, the net amount at risk for the year is the benefit on death less (i) the accumulating fund (determined without regard to any policy loan) or (ii) the CSV, depending on the method regularly followed by the insurer, and determined as of the end of the calendar year.

For G3, the net amount at risk for the year is the benefit on death less the greater of (i) cash surrender value of the policy; and, (ii) net premium reserve of the policy as of the end of the calendar year.

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EXAMPLE (CONT'D)

Aron owns a universal life insurance policy insuring his own life for a level death benefit of $100,000. The policy has a CSV of $18,900, so the amount of risk in the context is $81,100 ($100,000 - $18,900 = $81,100). The ACB of the policy at the beginning of this year was $16,050. If the NCPI table rate for Aron's age and gender is $12.10/$1,000 for this year, the NCPI adjustment to the ACB of the policy will be $12.10 x $81.1 (thousands), or $981.31. Ignoring any other factors (such as premium deposits), the NCPI adjustment for Aron's policy will "grind down" the ACB of the policy by $981.31, from $16,050 to $15,068.69.

One ACB per Policy

There are situations where there may be more than one owner of a single insurance policy and each owns an interest in that policy. It is up to the policy owners to track the ACB of their interest in the policy because insurance companies track only one ACB and use that single ACB for all transactions involving that policy.

In addition, when a term insurance policy has been converted, the amounts used in calculating the ACB of the original policy are carried forward and apply under the converted policy.

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The ACB Effect on Certain Policy Transactions

The ACB affects various policy transactions, as demonstrated in the following scenarios.

1. Where the sum of the amounts that reduce the ACB exceeds the sum of those that increase the ACB (i.e. the balance is negative), the ACB is deemed to be zero. This has two implications. First, even though the policy is in a gain position, that gain is not taxed. Second, a taxable policy gain can never exceed the proceeds of disposition.
2. The NCPI deduction can have a significant impact as a policy gets older. Where it exceeds the premium payment under an exempt policy, it produces a year-over-year decline in the ACB. The result is a smaller amount that can be withdrawn tax-free from the policy. Eventually, the ACB of an exempt policy can be deemed to be zero.

EXAMPLE (CONT'D)

In Aron's case the NCPI adjustment for the current year was calculated to be $981.31. If he is paying premium deposits into the plan of $500 a year, the net effect for the year will be a reduction in the ACB of the policy of $481.31 ($500 - $981.31 = $481.31).

3. In the case of a non-exempt policy, the NCPI deduction increases the amount of income taxed on an accrual basis; this taxed income is added back to the ACB, which therefore remains high.

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Taxation on Policy Dispositions

The excess of the proceeds from the disposition of a life insurance policy over the policyholder's ACB is included in the policyholder's income for the year of disposition. It is important to consider the cumulative effect of various transactions; even the payment of dividends may produce taxable policy gains. The ACB calculation will be different for G2 and G3 policies.

Death Benefit Under an Exempt Policy

Where the life insured under an exempt policy dies, no part of the death proceeds is subject to tax because the death of the life insured under an exempt policy is not considered a disposition of the contract.

Death Benefit Under a Non-Exempt Policy

When the life insured of a non-exempt policy dies, income accrued to the date of death is taxable to the policyholder. Where the life insured is the policy owner, the income is reported in the final tax return of the deceased.

Third-Party Life Insurance

Where the owner of a policy insuring another person (a third-party) dies, income accrued to the date of death is reported in the final tax return of the deceased policy owner, whether the policy is exempt or non-exempt unless a rollover applies. When the policy owner passes away, the contract is transferred to the contingent owner if one is named in the policy; otherwise, it goes to the estate of the deceased. Under either circumstance, a disposition arises.

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EXAMPLE

	Exempt policy	Exempt policy	Exempt policy	Non-exempt policy
Policy owner	A	B	C	D
Contingent owner	None	Spouse of A	Spouse of C	E
Life insured	A	A	A	F
Death of policy owner	Contract matures because of death of life insured. No disposition.	Ownership changes to spouse of A as contingent owner. Policy gain equal to excess of CSV over ACB.	Ownership changes to surviving spouse as contingent owner. Tax-free rollover to spouse of C with no disposition (unless estate executor elects out of rollover).	Income to the date of death of the policy owner is reportable on the terminal tax return. Ownership of the policy transfers to person E.

Income Inclusion

A policy owner must include as income any policy gains realized to the extent that the proceeds of disposition exceed the ACB of the policy holder's interest immediately before the disposition:

Taxable policy gain = Proceeds of the disposition – ACB

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EXAMPLE

Shiri owns a whole life insurance policy with a face amount of $50,000, a CSV of $11,100, and an ACB of $3,800. If she surrenders the policy, she must report a taxable policy gain of $7,300 ($11,100 - $3,800 = $7,300).

The full excess is subject to tax because it is a gain but not a capital gain.

Once the ACB has been reduced to zero, all of the proceeds of disposition become taxable.

It is always the policy owner who is taxed on a disposition, even if someone else receives the proceeds. For example, if a policy is surrendered to repay a collateral assignee, the policy gain is still taxable to the policy owner.

Definition of Disposition

A **disposition** of an interest in a life insurance policy includes all of the following:

1. A surrender (including a partial surrender)
2. Policy loans (including automatic premium loans and capitalization of unpaid loan interest)
3. The maturity of the policy (e.g. as an endowment)
4. A disposition by operation of law (e.g. voiding a policy)
5. Lapse due to non-payment of premiums (where the policy is not reinstated during the calendar year of lapse, or within 60 days thereafter)
6. Declaration of policy dividends
7. Absolute assignment (e.g. transfer of ownership by gifting or selling the policy, or on the death of the owner of a third-party policy)
8. Termination due to death of a non-exempt policy last acquired after December 1, 1982
9. When an exempt policy becomes non-exempt
10. Annuitization of a policy last acquired after December 1, 1982

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Transactions Not Considered Dispositions

The following transactions are specifically not considered dispositions and therefore do not trigger taxation:

1. Termination of the policy due to death of a policy owner last acquired before December 2, 1982, or an exempt policy
2. Collateral assignment
3. Lapse due to non-payment of premiums where the policy is reinstated during the calendar year of lapse, or within 60 days thereafter
4. Payment under a policy as an accidental death benefit or a disability benefit
5. Annuitization of a policy last acquired before December 2, 1982
6. Election of extended term insurance non-forfeiture option
7. Certain policy changes (i.e. see Grandfathering)

Proceeds of Disposition

The **proceeds of disposition** of an interest in a life insurance policy is the amount that the policyholder, beneficiary, or assignee is entitled to receive on the disposition of the interest, but does not include dividends left on deposit and interest thereon. The proceeds of disposition are calculated differently for each of the following events.

1. **On surrender or maturity of the policy, including annuitization**, the proceeds of disposition is the amount by which the CSV, less any amount in respect of a segregated fund, exceeds the aggregate of any policy loan outstanding and premium due but unpaid. This amount is sometimes referred to as the net cash surrender value.
2. **On taking a policy loan**, the proceeds of disposition is the lesser of the amount of the loan (other than an amount applied immediately to pay a premium under the policy) and the excess of the CSV over any existing policy loan. For automatic premium loans qualifying under the rules for internal policy transactions, the proceeds of disposition are nil.

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3. **On death of the life insured under a non-exempt policy last acquired after December 1, 1982**, the proceeds of disposition are the accumulating fund of the policy immediately before death.
4. **On declaration of a dividend**, the proceeds of disposition are the amount of the dividend, excluding any part of such dividend that qualifies under the rules for internal policy transactions.
5. **On an exempt policy becoming non-exempt**, the proceeds of disposition are the accumulating fund of the policy.
6. **On the absolute assignment of the policy to an arm's length party**, the proceeds of disposition are the consideration paid for the policy, if any.
7. **On absolute assignment of the policy by gift or other non-arm's-length transfer,** the proceeds of disposition are the greater of ACB, CSV and FMV of consideration paid.
8. **Where tax-free rollover provisions apply**, the proceeds of disposition is equal to the ACB of the interest to the policyholder immediately before the transfer.

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Dividends

The declaration, payment, or crediting of a policy dividend by the insurance company is deemed a disposition of an interest in the policy by the policy owner. The amount of the dividend becomes the proceeds of disposition, and the ACB is reduced by that amount. If the amount of the dividend exceeds the ACB, the excess is subject to tax. The amount included in income is then added back to the ACB to avoid double taxation.

EXAMPLE 1

Betty owns a participating whole life insurance policy with a face amount of $100,000 and an ACB of $12,820. Betty is taking her annual dividend in cash, paid out of the policy to her each year. This year's dividend is $1,100. Because the amount of the dividend is less than the ACB of the policy, the dividend is paid to Betty tax-free and the ACB of the policy will be reduced by the amount of the dividend, from $12,820 to $11,720 (ignoring all other factors, such as the payment of premiums and the NCPI calculation for the year).

EXAMPLE 2

Cara owns a participating whole life life insurance policy with a face amount of $50,000 and an ACB of $840. She is taking her annual dividend in cash, paid out of the policy to her each year. This year's dividend is $900. Because the amount of the dividend is greater than the ACB of the policy, the dividend will, in effect, be paid to her tax-free, and the ACB of the policy will be reduced by the amount of the dividend, from $840 to nil (ignoring all other factors, such as the payment of premiums and the NCPI calculation for the year). The balance of the dividend, $60, will be paid to her as a taxable policy gain and will initially reduce the ACB of the policy to a negative amount. However, the policy gain is then added back to the ACB of the policy, resulting in a nil ACB.

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Policy Dividends

A policy dividend is essentially treated as a return of premiums. For policies last acquired before December 2, 1982, the policyholder's cost equals net premiums (ignoring any other transactions). Once the sum of the cash dividends is greater than the sum of the gross premiums, a taxable profit arises. For policies last acquired after December 1, 1982, the NCPI deduction in the ACB calculation tends to accelerate and increase taxable profits arising out of dividend payments.

Absolute Assignment

The **absolute assignment** of an interest in a policy is a disposition by the policy owner who must report as income any excess of the proceeds of disposition over the ACB. If the ACB of the assignor exceeds the proceeds of the disposition, the realized loss is not deductible, nor is it carried forward for the tax benefit of the new policyholder.

EXAMPLE

Rita and her partner, Joe, had whole life insurance policies on each other's life to help fund a business buy/sell agreement in the event of either of their deaths or retirement. They decide to dissolve their business venture and "swap" policies by way of absolute assignments. At the time of the swap, the policy on Joe's life has a CSV of $3,400 and an ACB of $4,200. Rita is deemed to dispose of the policy for proceeds equal to its CSV and reported no policy gain because the ACB of the policy exceeded its CSV. Nor could Rita claim the policy "loss" as a deduction for tax purposes. Joe receives the policy with an ACB equal to Rita's deemed proceeds of disposition of $3,400 (its CSV) rather than Rita's ACB of $4,200.

The calculation of the proceeds of disposition and the resulting tax implications depend on the circumstances. In order to establish full records and permit proper tax reporting, the insurer must be told about the relationship between the parties to the transfer and the amount of consideration received.

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Collateral Assignment

The **collateral assignment** of an interest in a life insurance policy does not constitute a disposition of the interest for tax purposes and does not trigger any tax reporting.

EXAMPLE

Julia owns a universal life insurance policy with a CSV of $14,200 and an ACB of $5,300. Needing additional capital for her unincorporated business, Julia borrows $10,000 from the bank, collaterally assigning her universal life plan to the bank as security for the loan. Because the assignment is a collateral assignment, Julia does not have to report any taxable policy gain as a consequence Of the transaction, even though her $10,000 loan exceeds (by S4,700) the ACB of the assigned policy.

Policy Loans

A **policy loan** is an amount advanced by an insurer to a policy owner against the CSV of the policy and is a contractual provision in the terms of the policy.

Taking a policy loan constitutes a disposition for tax purposes. The proceeds of the disposition equals the lesser of (i) the amount of the loan, and (ii) the CSV minus the outstanding balance of any previous policy loan. This limits the amount of the loan (i.e. the sum of any outstanding and new loans) for income tax purposes to the amount of the CSV of the policy.

EXAMPLE

Ardis owns a universal life insurance policy with a CSV of $10,300. He currently has $6,000 in loans outstanding against the policy and another $1,100 in outstanding, unpaid interest arising from those loans. If the policy contract allowed policy loans to 100% of CSV, the maximum additional loan that Ardis can take against the policy is $3,200 ($10,300 – ($6,000 + $1,100)); the net CSV.

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Where the proceeds of disposition exceed the ACB of the policy, the excess is included in income as a policy gain, and the ACB is increased by the amount of that excess.

EXAMPLE

If the ACB of Ardis' policy, above, was $8,000 before any of the policy loans and he takes out another policy loan equal to the net CSV of the plan ($3,200), $2,300 of the loan proceeds ($10,300 – $8,000) would be treated as a taxable policy gain in his hands. The ACB would initially go negative, but the ACB of the policy would subsequently be increased to nil due to the income inclusion of $2,300.

On repayment of all or part of a policy loan, the policyholder may deduct from income the lesser of (i) the amount of the repayment, and (ii) the amount previously taxed to him in respect of the policy loan. The ACB of the policy is increased by all policy loan repayments unless such repayment is deductible from income.

EXAMPLE

If Ardis repays $2,000 of his $10,800 policy loan, he can claim a deduction for tax purposes of $2,000 (the lesser of the loan repayment and policy gain previously reported). Since a deduction has been claimed, this repayment is not added back to the ACB of the policy.

There are no reporting requirements for loan repayments, but insurers advise policyholders of the amounts eligible for deduction as a consequence of such repayments.

Generally, life insurance companies do not extend policy loans greater than 90 percent of the CSV of the policy.

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Policy Loan Interest

Interest paid on a policy loan is treated as a premium outlay. Accordingly, loan interest repayments are added to the ACB, similar to premiums. This ensures the policy owner's payments into the policy do not later emerge as taxable income.

The previous rule does not apply if the money borrowed is used to earn income from a business or property and the policy holder claims a deduction for the loan interest under paragraph 20(1) (c) or (d)of the ITA. To claim loan interest as a deduction, the policyholder must ask the insurance company for a completed Form T2210, Verification of Policy Loan Interest by the Insurer.

If the loan interest is not paid, it is capitalized as a new policy loan. Under the rules for internal policy transactions, the proceeds of disposition for the new loan is nil and the deemed interest payment cannot be added to the ACB.

Policy Transfer to Family Members

In certain circumstances, subsection 148(8) to (8.2) of the ITA provide for an automatic rollover on the transfer of an interest in a life insurance policy to a child, spouse, or common-law partner (including certain transfers to a former spouse or common-law partner) of a policyholder. Where one of the tax-free rollover provisions apply, the transferor is deemed to have received proceeds of disposition equal to her ACB in the interest of the policy disposed of. The transferee is deemed to have acquired the interest in the policy at a cost equal to those proceeds.

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Transfer to Children

This tax-free rollover (subsection 148(8)) applies where an interest in a life insurance policy on the life of a child has been **transferred to a child** for no consideration. This must be a direct transfer from the policy owner to the child. Examples include a lifetime transfer of ownership and a transfer at death under a successor owner designation under the policy (also referred to as contingent owner).

EXAMPLE

Dara owns a whole life insurance policy on the life of his son, Ronald, taken out when Ronald was one year old. The policy currently has a CSV of $8,100 and an ACB of $4,300. Because Ronald recently turned 21 and is working full-time, Dara decides to execute an absolute assignment and transfer the policy to Ronald for no consideration. Under the tax-free rollover provisions, Dara is deemed to have disposed of the policy for proceeds equal to his ACB of $4,300 (and therefore does not have to report $3,800 in policy gain) and Ronald is deemed to acquire the policy at an ACB equal to Dara's deemed proceeds.

A transfer from a trust to a child does not qualify under this tax-free rollover provision (subsection 148(8)). The ITA contains rollover rules for transfers from a trust to a beneficiary at the ACB of the policy. This means a trust can distribute a life insurance policy to a beneficiary of the trust for proceeds equal to the ACB of the policy. The beneficiary's starting ACB would be equal to the trust's ACB of the policy.

The CRA has ruled that the rollover provision does not apply to a policy transfer to a child under the parent's will because the policy is moving from the parent to the parent's estate and then finally to the child.

In addition, the tax-free rollover provisions do not apply if more than one life is insured under the policy. This results from a strict reading of the provision which says, "the life insured is a child of the policy owner." The CRA has interpreted this phraseology to mean that only one life can be insured under the policy for the rollover rules to apply.

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For this purpose, ss. 148(9) extends the meaning of child to include a grandchild, a great- grandchild, and a person who, at any time before attaining age 19, was under the custody and control of the policyholder and wholly dependent on him or her for support.

The transferee child need not be the same person as the child whose life is insured. For example, a policy on the life of the policy owner's son can be rolled tax-free to the policy owner's grandson or daughter-in-law.

Inter Vivos Transfer to Spouse/Partner

An inter vivos transfer of a life insurance policy to a spouse or common-law partner (subsection 148(8.1)) can be completed on a tax-deferred basis. This tax-free rollover provision applies to lifetime transfers to the policy owner's spouse or common-law partner, as well as transfers to a former spouse or common-law partner in settlement of rights arising out of a marriage or common-law partnership. Both the policy owner and the transferee (receiving party) must be resident in Canada at the time of transfer.

The rollover treatment applies to life insurance policies regardless of whose life is insured. Though there is no requirement that the transfer be without consideration, an election may be made that the regular disposition rules apply and the policy gain (if any) be reported in the hands of the transferor for the year of transfer.

Transfer to Spouse/Partner on Death

A testamentary transfer of a life insurance policy to a spouse or common-law partner (subsection 148(8.2)) can be completed on a tax-deferred basis. A tax-deferred rollover of a life insurance policy is permitted to the deceased owner's spouse or common-law partner provided that both the policy holder and the survivor were resident in Canada immediately before death. For this purpose, a transfer by way of successor owner designation as well as a transfer under the terms of the policy owner's will both constitute a transfer as a consequence of death.

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The rollover treatment applies to life insurance policies regardless of whose life is insured. Though there is no requirement that the transfer be without consideration, an election may be made that the regular disposition rules apply and the policy gain (if any) be reported in the hands of the transferor for the year of transfer.

Tax-free rollovers can be beneficial for two reasons:

- Where the ACB exceeds the net CSV, the transferee takes over a higher ACB than under the regular disposition rules.
- Where the net CSV exceeds the ACB, the taxation of the policy gain is deferred.

Split Dollar

Split dollar insurance may also be referred to as shared ownership or joint ownership insurance. Split dollar life insurance is a way to share premium costs, cash values, and death benefits of a single life insurance policy between two or more parties based on their unique needs. Split dollar insurance would be evidenced by an agreement between the two parties setting out their unique benefits and obligations. The agreement is very important because the life insurance carrier can only record the policy as jointly owned; without an agreement, the owners would have equal rights under the policy.

Split dollar is possible because the ITA references a policyholder's interest in the policy in many of the provisions applicable to life insurance policies.

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Assessing a Split Dollar Situation

Over the years, the CRA has refused to publish a definitive position on how it would assess a split dollar situation. This has caused many practitioners to use great care in constructing split dollar recommendations. In general, it is best to ensure that each is paying a fair value for their interest in the jointly owned life insurance policy. Split dollar arrangements may result in a taxable benefit to the employee/shareholder to the extent they pay less than FMV for their interest in the policy.

One example of split dollar insurance would be an agreement between an operating company and its shareholder.

- The shareholder would be the life insured under the contract;
- The company would own the cash value component of the contact;
- The shareholder would own the death benefit component of the contract.

The shareholder would pay towards the policy an amount equal to the fair value of the benefit being enjoyed. This shareholder could pay an amount equal to an annual renewal term, a 10-year renewable term or even term-to-100 for the amount of the death benefit available to the shareholder. The corporation would pay the portion of the premium in excess of that paid by the shareholder.

Examples of other split dollar arrangements would include:

- The shareholder owning the cash value and the company owning the death benefit;
- The employee owning the death benefit and the company owning the cash value;
- The child owning the death benefit and the parent owning the cash value;
- The trust owning the cash value and the beneficiary owning the death benefit.

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Taxation of the Policy Death Benefit

Death of a Policy Owner: Not the Life Insured

The death of the owner of a cash value life insurance policy where the owner is not the life insured triggers a deemed disposition of the contract in the hands of the deceased owner for the year of death.

In all cases, the policy gain (the excess of the policy's CSV over its ACB) is reported as income to the policy owner for the year of death.

EXAMPLE

Tom owns an exempt universal life insurance policy on the life of his business partner. The purpose of the insurance is to fund a retirement or death buy/sell agreement. Tom dies and, at the time of his death, the policy has a face amount of coverage of $250,000, a CSV of $42,000, and an ACB of $27,200. The policy is not transferred to Tom's surviving spouse but to Tom's estate.

A policy gain of $14,800 ($42,000 CSV – $27,200 ACB = $14,800) must be reported on Tom's final tax return as a consequence of the deemed disposition of the policy arising on his death. His estate (the successor owner of the policy) acquires the contract with an ACB of $42,000 (the CSV of the policy at the time of Tom's death).

Death of Life Insured: Exempt Policies

In the case of exempt life insurance, the death of the life insured does not result in a disposition for income tax purposes. This is the case whether the life insured is the policy owner or a third-party. There is no tax reporting to the policy owner, the life insured (if different), or the beneficiary who receives the death benefit proceeds.

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EXAMPLE

Arnie owned a $100,000 exempt level death benefit universal life insurance policy on the life of his wife, Hilda, who died last year. He was the named beneficiary under the contract. At the time of Hilda's death, the policy had a face amount of coverage of $100,000, a CSV of $14,200, and an ACB of $6,000. Because the policy was exempt, Hilda's death did not trigger a disposition of the contract for tax purposes, and the $8,200 policy gain ($14,200 - $6,000 = $8,200) is not reported as income to Arnier for the year of death. The $100,000 policy death benefit was received tax-free by Arnie as beneficiary.

Death of Life Insured: Non-Exempt Policies

In the case of a non-exempt life insurance policy, the death of the life insured constitutes a deemed disposition of the policy for proceeds equal to its CSV. As a consequence of the disposition, all policy gain accrued since the last income reporting date (the last policy anniversary) is reported as income to the policy owner for the year of death, regardless of whether the life insured under the policy is the policy owner or a third-party. The policy death benefit remains tax-free in the hands of the beneficiary.

EXAMPLE

Petra owns a non-exempt universal life insurance policy on the life of her business partner. Petra's brother, Jean, is the successor owner of the policy, should Petra die while her partner is still alive. On its last anniversary date, $820 of policy gain was reported to Petra as taxable income (the difference between the policy CSV of $22,400 and the ACB of $21,580). At that time, the ACB of the policy was bumped up to equal its CSV of $22,400. If Petra were to die today (the CSV of the policy increased to $22,960 in the intervening six months), a taxable policy gain of $560 ($22, 960 - $22,400) would be added to Petra's income for the year of death. Petra's brother would receive the policy with an ACB of $22,960 (equal to the policy ACB of $22,400 at the last policy anniversary, plus $560 policy gain reported to Petra at the time of her death.

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The amount of taxable policy gain reported at the death of the life insured (or the policy owner) under a non-exempt policy is relatively small (compared to a disposition of a similar exempt contract). This result arises because the reported policy gain accrues only since the last reporting date (i.e. the last policy anniversary, so not more than one year before).

If the policy owner is not the life insured under the contract, the successor owner of the policy (i.e. the policy owner's estate or a named third-party) receives the policy with an ACB equal to the deemed proceeds in the hands of the deceased policy owner. This negates the possibility of double taxation of the policy gain accrued between the policy's last anniversary and the date of death (i.e. once on the deceased's terminal tax return for the year of death and again in the hands of the successor owner, at the next policy anniversary).

Insurance Leveraging Programs

Using a collateral assignment and a third-party lending institution, leveraging against an insurance policy is an alternative method of accessing the value accumulated inside the policy. The conventional methods of accessing the cash value are systematic partial withdrawals and policy loans. However, there are income tax implications with the conventional methods, so leveraged programs were developed.

The typical process of a **leveraged insurance strategy** is as follows:

1. A policy owner acquires an exempt insurance policy for estate or business succession planning purposes.
2. The policy owner makes additional deposits that accumulate on a tax-deferred basis within the policy.
3. At a later date, the policy owner accesses the accumulated values within the policy through a policy loan or a collateral loan from a financial institution.
4. Depending on the use of the borrowed funds, the interest may or may not be tax-deductible.
5. The outstanding loan and any accrued interest can be repaid during the borrower's lifetime, with any remaining loan outstanding on death repaid through the insurance death benefit.

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In order to obtain interest deductibility for interest payments, the loan proceeds must be invested in qualifying investments that meet the requirements of paragraph 20(1)(c) of the ITA.

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Annuities

Annuities are an important component of retirement income planning, and a thorough understanding is necessary to ensure a good fit with the client's objectives. There are many different components to the design of an annuity, each with its own advantages and disadvantages.

Types of Annuities

An **annuity** is a contract whereby an insurance carrier promises to pay a periodic payment to the annuitant for a predetermined amount of time. There are many different types of annuities, including:

- **Registered** and **non-registered annuities;**
- **Deferred** and **immediate annuities;**
- **Life** and **term certain annuities;**
- Life annuities with and without guarantees.

Annuities can be purchased with registered or non-registered funds. In either case, the payments can be immediate or deferred. With an immediate annuity, payments begin at the end of the first period after purchase (monthly or annually); while a deferred annuity is used to accumulate funds over time with payments set to begin at some future date.

Payments may continue for the annuitant or joint annuitant's lifetime (life annuity/joint last to die annuity), or for a certain number of years (term certain annuity). An annuity designed to pay out over the annuitant's lifetime could be structured to guarantee a minimum number of payments. If an annuitant passes away before the minimum number of payments occurs, the outstanding number of payments in the guaranteed period would be paid to the named beneficiary of the policy.

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The following discussion focuses mainly on the taxation of non-registered annuities. Though registered annuities are addressed briefly, they are discussed in more detail in the Retirement Income Module.

Tax Treatment of an Annuity Contract

Tax treatment depends on the type of annuity contract. Non-registered annuities are taxed in one of two ways:

- Annual accrual method;
- Prescribed method (may also be referred to as proportional method).

Immediate annuities can be taxed either way. Deferred annuities are taxed on the annual accrual basis during the accumulation period, and can be taxed either way during the payout period.

The table below summarizes the tax treatment of immediate and deferred annuities.

	Registered	**Non-Registered**
Deferred Annuity	Payments fully taxed when received.	Accrual taxation during accumulation period.
Immediate Annuity	Payments fully taxed when received.	Some of the payments taxed when received. May quality for prescribed tax treatment.

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Annual Accrual Method

With the **annual accrual method**, the income to be taxed is calculated on each anniversary date of the contract, calculated as the amount by which the accumulating fund exceeds the ACB of the contract.

The ACB of the contract includes:

1. Premiums paid for the contract, ***plus***
2. Accrued income previously reported, ***plus***
3. The mortality gain (loss) for the year, ***less***
4. Annuity payments received during the year.

Regulation 307 of the ITA sets out how the accumulating fund is to be calculated. Where the annuity contract is issued by a life insurer, the accumulating fund equals the Maximum Tax Actuarial Reserve (MTAR). Where the contract is not issued by a life insurer, the accumulating fund equals the CSV minus any policy loans outstanding. It is the contract owner who is taxed on the income. Where the annual accrual method is used, the receipt of an annuity payment does not trigger any additional tax consequences.

There are two exceptions to the application of the annual accrual method:

- Annuity contracts acquired before December 2, 1982, where annuity payments began before that date are not subject to the accrual rules;
- Annuities acquired before 1990 are taxed on the accrual basis at the end of every third calendar year.

Taxation on the Accrual Method

Taxation on the accrual method is much more complex than taxation on a prescribed basis. The following values are hypothetical and intended only to demonstrate how accrual taxation works.

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EXAMPLE

A corporation (holding company) is using $100,000 to buy a non-registered annuity on the life of a 70-year-old female and wants to guarantee 120 payments. This situation does not qualify for prescribed tax treatment because a corporation is the annuity's owner. The annual taxation of the annuity would be the difference between the accumulating fund and the adjusted cost basis. The annual taxable portion reported by the life insurance carrier to the holding company would be as follows:

Yr 1: Nil

Yr 2: Nil

Yr 3: $2031.50

Yr 4: $2,148.56

Yr 5: $2,063.41

Yr 6: $1,977.84

...and so on.

The taxable portion gets systemically smaller each subsequent year.

Prescribed Tax Treatment

The **prescribed method** applies to annuities that meet the definition of a prescribed annuity contract, as set out in Regulation 304 of the ITA. Essentially, the annuity must be an immediate annuity issued by a qualified issuer, where the contract owner and the annuitant are the same person. Payments must be made for life or for a fixed term that does not extend past the 91st birthday of the holder or the survivor, whoever is younger (assuming a joint annuity). A non-registered annuity issued after 1986 that meets the requirements under Regulation 304 is automatically considered a prescribed annuity unless the holder notifies the issuer otherwise in writing.

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Where the accrual rules do not apply, the full amount of all annuity payments received in the year is included in the annuitant's income (Paragraph 56(1)(d)).The annuitant may then deduct the tax-free capital element of these annuity payments (Paragraph 60(a)). In practice, however, only the taxable portion of such payments is reported on form T4A and on the income tax return.

Calculating the Capital Element

From a tax point of view, each payment from a prescribed annuity is considered a blend of interest and capital in a ratio that remains constant for the life of the contract. The rules for calculating the capital element of each annuity installment are contained in Regulation 300 of the ITA. This calculation involves four steps.

Step 1: The capital element of the whole annuity contract is determined.

Step 2: The number of annuity payments is determined.

Step 3: The proportion of each annuity payment that is the capital element is determined.

Step 4: The capital element of each annuity payment is determined.

Step 1: Determine the Capital Element

The capital element of the whole annuity contract needs to be determined. Where cash is used to purchase an immediate annuity contract, the premium paid becomes the capital element, also referred to as the "adjusted purchase price." For annuities under deferred annuity contracts and other life insurance policies, various adjustments may be required, or special rules applied, for determining the adjusted purchase price.

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Step 2: Determine the Number of Annuity Payments

The **number of annuity payments** needs to be determined.

- For term certain annuities, this number is simply the product of the term in years and the number of payments in each year;
- For life annuities, the number of payments expected is based on life expectancy using the Annuity 2000 Basic Mortality Table. The life expectancy figure is multiplied by the number of payments per year in order to determine the total number of payments expected under the contract.

Step 3: Determine the Proportion of Each Annuity Payment

The **proportion of each annuity payment** that is the capital element is determined by dividing the adjusted purchase price by the total amount of the payments (expected) to be made.

Step 4: Determine the Capital Element of Each Annuity Payment

The **capital element of each annuity payment** is determined by multiplying the percentage obtained in Step 3 by the amount of each annuity payment.

EXAMPLE

Emma Smith invests $100,000 into a life annuity that will pay her $659.96 per month. Using the mortality table prescribed by the ITA, Emma is expected to receive 240 payments. Each payment received will be comprised of $416.67 of capital ($100,000 divided by 240 monthly payments) and the difference of $243.29 would be the taxable amount.

Where the amount of the annuity payments varies, such as through integration with government benefits or a reduction after the death of the first annuitant under a joint and last survivor annuity, the amount of the capital element varies in the same proportion (i.e. the fraction determined in Step 3 remains constant). Any excess over the capital element is taxable, including any dividends and excess interest.

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Annuity Premiums

Premiums paid for non-registered annuity contracts are not tax-deductible. Interest on money borrowed to acquire an annuity is deductible up to the income inclusion where the accrual rules apply, but not where the contract is taxed on the prescribed basis.

Taxation on Disposition

As with other life insurance policies, the amount subject to tax on disposition is the excess of the proceeds of the disposition over the contract's ACB. On full disposition, all income that has not been previously taxed is brought into income.

Taxation on Death

Under the accrual method, there is a deemed disposition immediately before the death of the annuity owner. This applies whether the owner dies during the accumulation or the payout period. At this point, any accrued income up to the date of the owner's death that has not yet been reported is brought into income and reported on the owner's terminal tax return.

Where the contract is transferred to a spouse or common-law partner on death, a rollover provision applies. The proceeds of disposition are considered to be equal to the contract owner's ACB immediately before the transfer. The owner's estate executor may opt out of the tax-free rollover provision by filing an election with the deceased's terminal tax return.

Under the proportional method, though there is technically an actual disposition of the contract on the owner's death, no tax is payable because it is the payments rather than the ownership interest that is subject to taxation. In practice, prescribed annuities are treated as if no disposition applies.

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When a lump sum is payable to a beneficiary on death, there are no tax implications to the beneficiary. However, there is a taxable disposition at this time. In the case of a prescribed annuity, any gain is reported on the deceased annuitant's terminal return. With an annuity that is taxed under the accrual method, taxable proceeds equal the value of the accumulating fund immediately following death.

For life annuities purchased prior to November 13, 1981, the entire proceeds are exempt from tax.

Charitable Annuities

A **charitable annuity** is a planning strategy utilized by older clients to provide income and, at the same time, help a charity. The donor makes a gift of capital to a registered charity in return for a promise by the charity to pay a regular income to the donor.

Charitable annuities issued before December 21, 2002, are taxable to the donor on the prescribed basis. Where the contribution exceeds the total amount of payments expected, the excess is treated as a charitable donation and the annuity payments are treated as a tax-free return of capital.

The rules in effect for charitable annuities issued after December 20, 2002, allow charities to give partial consideration back to the donor and issue a charitable receipt for the difference. The amount of the gift is defined as the excess of the FMV of the assets donated over the amount of the benefit given back to the donor. This method results in a larger donation receipt, because the calculation of the benefit received from the charity is based on the present value of the future annuity payments, rather than simply the sum of those payments. The payments to the donor will be taxed on either the accrual or prescribed basis depending on the arrangement between the donor and the charity.

As an alternative to directly gifting the capital to the charity, the donor could purchase a prescribed annuity from an insurance company and gift all or just the taxable portion of the annuity income as a charitable gift to the registered charity.

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The donor could also purchase an insurance policy to replace on death the capital that has been used to purchase the annuity. Again, all or a portion of the death benefit can ultimately be transferred to the charity as a charitable gift. The benefit of this strategy over a traditional charitable annuity is the donor retains a greater degree of control over the annuity and annuity payments.

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Segregated & Mutual Funds

Segregated funds are often referred to as the insurance industry's equivalent to mutual funds. While this description is valid, there are important differences between the two structures, including the fact that mutual funds can be set up as trusts or corporations, each with their own features and benefits. Segregated funds are regulated under provincial insurance legislation.

The discussion that follows relates to the tax treatment of mutual funds and segregated funds when held in a non-registered account. Income and capital gains within a registered account accrue until money is withdrawn from the account. At that point, the withdrawals are fully taxable. Further discussion on the taxation of registered funds is covered in the Retirement Income module.

Most Canadian mutual funds are structured as mutual fund trusts.

Mutual Fund Trusts

Income earned in a **mutual fund trust** can be either retained in the trust or paid out to the unitholders. When paid out to unitholders, the income retains its character as interest, dividends, capital gains, or foreign source income, and is taxed in the hands of each unitholder as if the unitholder had received it directly. Any income retained in the trust is taxed at the highest marginal tax rate applicable, without the benefit of personal tax credits. Because there is no tax advantage to retaining income in the trust, most mutual fund trusts are created to take maximum advantage of the flow-through nature of the trust structure.

However, mutual fund trusts cannot allocate capital losses to their unitholders. Any capital losses realized during the year must first be offset against capital gains; any net losses remaining can be either carried back three years or carried forward indefinitely. Because all income and gains are usually allocated to unitholders, net losses are usually carried forward.

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Most mutual fund trusts make one annual distribution to their unitholders at the end of the year, although funds that earn primarily interest income often distribute more frequently. Income is distributed to unitholders of record on the distribution date and is not prorated for those who have not held the investment for the full period. Distributions are usually used to purchase new units.

Any amounts distributed by the trust in excess of the income allocated for the year are treated as a tax-free return of capital, and the ACB of the units is reduced accordingly.

The redemption of units in a mutual fund trust is treated as a disposition for tax purposes. The ACB of a unit is calculated as the weighted average cost of all units in the pool, where cost is the original purchase price plus any acquisition costs such as front-end loads. Mutual funds are not required to track the capital gains or losses that unitholders realize on redemption.

Mutual Fund Corporations

The main difference between mutual fund trusts and **mutual fund corporations** is that the corporate structure provides for separate investment funds to be offered by the same corporation, with a separate class of redeemable and convertible shares issued by each fund (multi-class funds).

A mutual fund corporation does not allocate income in the same way as a mutual fund trust. Mutual fund corporations pay both capital gains dividends and taxable dividends to their shareholders. A capital gain dividend is taxed as a capital gain. Note that a taxable dividend qualifies for the dividend tax credit.

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Segregated Funds

Investors do not technically buy **segregated funds** but rather invest in them by buying segregated fund policies or individual variable insurance contracts. Similar to life insurance policies, segregated fund policies enjoy creditor protection under provincial insurance legislation.

As the name suggests, assets in a segregated fund are notionally segregated from the insurer's other assets. They are not held in trust (insurance companies cannot act as trustees), but from a tax perspective are treated, for the most part, as inter vivos trusts with the insurer deemed to be the trustee and the policy owners the beneficiaries. The income of the fund is taxed in the hands of the policy owners in the same way that income from a mutual fund trust is taxed in the hands of the unitholders (i.e. it retains its character as interest, dividends, or capital gains).

Taxation of Mutual Funds & Segregated Funds

There are three important differences in the structure and taxation of segregated funds and mutual funds.

- A segregated fund is deemed to have distributed all its income to the unitholders each year. Though mutual funds have the option of retaining income, they seldom do because it would be taxed at the top marginal rate.
- A segregated fund is required to flow through capital losses to its policy owners who can use these losses to offset capital gains from other property. The losses can be carried by the investor to other years according to the usual carry-forward and carry- back rules. Mutual funds are not allowed to allocate capital losses to their unitholders.
- Where mutual funds distribute and reinvest income earned by the fund to the unit holders of record on the distribution date, most segregated funds allocate income based on time- weighted units. This means segregated policy owners generally receive a proportional allocation of income or losses, depending on how long they have held their units. Distributions increase the value of each unit but do not result in an increase in the number of units or the total value of the fund.

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Segregated Fund Guarantees

Segregated funds offer additional benefits to the investor. The biggest difference between segregated and mutual funds is that segregated funds must **guarantee the return** of at least 75 percent of premiums paid on maturity of the policy or on death of the policy owner. Some companies provide maturity and death guarantees as high as 100 percent of total premiums paid.

This feature makes segregated funds exempt from securities regulation (segregated funds are regulated under provincial insurance legislation) and distinguishes them from mutual funds, which have no such guarantee.

Top-Up Payments

As of the time of writing, the tax treatment of a **top-up payment** made under the guarantee on a segregated fund is not clear. As the CRA has issued several interpretation letters suggesting that the payment should be treated as a capital gain, most insurers report the payment accordingly.

EXAMPLE

Chad McDonald invested $50,000 into a segregated fund policy. Over the course of his ownership, the fund earned absolutely no income, leaving Chad's ACB at exactly $50,000. Just before the policy's maturity date, the fund dipped in value to $40,000. Since Chad's fund matured for $40,000, he would realize a capital loss of $10,000.

Chad's segregated fund had a 100 percent maturity guarantee. This means on maturity of the policy, Chad received a top-up of $10,000 for a total of $50,000. The $10,000 top-up is reported as a capital gain.

Both the $10,000 capital loss and corresponding $10,000 top-up are reported in the year of disposition. The net effect to Chad for tax purposes is nil. The bottom line is that Chad invested $50,000 and realized $50,000 upon maturity.

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Disposition Under a Segregated Fund Policy

A **disposition** occurs when a segregated fund policy owner:

- Switches between funds offered under the same contract;
- Surrenders his or her interest in the policy;
- Exercises a maturity option; or,
- Dies.

EXAMPLE

Any gain or loss on disposition results in either a capital gain or capital loss. The ACB used in this calculation is equal to:

The total of all premiums paid plus income and capital gains allocated to the policy owner

LESS

Acquisition fees plus capital losses allocated to the policy owner

Death of the Policy Owner

Segregated fund contracts provide different options on the **death of the policy owner**. In some cases, the contract is terminated on death and a cash payment is made to the beneficiary. The tax treatment of the disposition follows the general rules for the disposition of non-registered capital property.

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Transfer to Policy Owner's Spouse

In other cases, the contract can be transferred to the policy owner's spouse, common-law partner, or spouse/partner trust on a tax-deferred basis. This transfer would occur if the spouse or common-law partner is named as a contingent owner in the policy or is named as the next owner of the policy under the deceased's will. The transfer of the policy to the deceased policy owner's spouse or common-law partner occurs on a **tax-deferred rollover** basis unless the executor of the deceased's estate elects out of the rollover. On this type of tax-deferred rollover, the proceeds of disposition are deemed equal to the original owner's ACB and the new owner assumes the original owner's ACB.

Third-Party Ownership

Segregated fund contracts can be owned by a third-party (i.e. the owner and the annuitant are not the same person). In this case, the taxation of the contract remains with the policy owner. If the third-party owner is an individual and pre-deceases the annuitant, the contract continues in-force. The deceased owner's interest is deemed to be disposed of and is subject to tax in his or her final income tax return. If, however, the policy is transferred to the policy owner's spouse, the tax consequences are as outlined in the section above.

A corporation could own a segregated fund contract and name an employee as the annuitant under the contact. The corporation will be responsible for reporting any income allocated from the contract; if the annuitant dies, taxable amounts are reportable by the corporation.

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Guaranteed Minimum Withdrawal Benefit Plans

The essential feature of a **Guaranteed Minimum Withdrawal Benefit (GMWB)** plan is that it is a guaranteed **Systematic Withdrawal Plan (SWP)** segregated fund product. The carrier contractually guarantees a conservative SWP.

EXAMPLE

George deposits $100,000 into a GMWB that guarantees to pay 5 percent per year for George's lifetime.

George can expect to receive $5,000 per year for the rest of his life. The carrier considers this $5,000 payment as the surrender of GMWB units. In this fashion, the payment is taxed as a capital disposition and the excess of the proceeds of disposition over ACB is a capital gain to George.

George is also taxable on the investment earnings within the GMWB. The carrier issues a T3 slip annually to report the annual investment earnings.

Upon George's passing, the market value of the GMWB is paid to his named beneficiary.

The GMWB contract can be enhanced with resets and guarantees, but the essential characteristic is a guaranteed SWP.

A GMWB can satisfy several issues facing a client with respect to retirement planning. A typical client faces three issues that must be addressed in their planning. The first is the risk of longevity because people are living longer than ever before, which means retirement planning must contemplate longer life expectancies. Second, the risk of inflation threatens to seriously erode purchasing power over time. The third consideration is market risk, which can seriously weaken the client's investment assets, both registered and non-registered.

A GMWB can provide lifetime income and protect the client against market volatility; however, it cannot fully protect against inflation.

A GMWB is a segregated fund policy, and is taxed as such. All taxable income and realized capital gains are allocated to investors. Income report on the policy will be a mix of interest income, dividends, foreign investment income, and capital gains/losses. Any capital guarantee benefits on death or contract maturity are taxed as a capital gain in the hands of the annuitant.

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Interest Deductibility

The general rule for **interest deductibility** is that interest paid on funds borrowed to purchase income-producing property or a business is tax-deductible. As such, interest on borrowed money used to buy a non-registered segregated fund annuity is tax-deductible. Similarly, interest on funds borrowed to invest in a non-registered mutual fund contract is tax-deductible.

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Living Benefits Products

The term **living benefits insurance** covers a wide range of insurance products that are designed to pay out a benefit while the policyholder is still living. These include:

- Wage loss replacement plan;
- Corporate-owned disability insurance;
- Business overhead insurance;
- Supplementary health insurance;
- Critical Illness insurance (CI);
- Long-Term Care insurance (LTC).

The ITA does not deal specifically with these products; however, the CRA has issued a number of interpretations over the past several years that most insurance companies rely on when marketing their products. Advisors are encouraged to be cautious when discussing the tax treatment of critical illness and long-term care products with their clients.

Wage Loss Replacement Plan

Disability insurance can be designed to protect an employee from loss of income due to accident or illness. The CRA refers to a group disability plan as a **Wage Loss Replacement Plan (WLRP)**.

To qualify as a WLRP, the insurance must be provided to all employees or to all employees within a defined group of employees. Examples of a defined group of employees include salaried employees, management, vice president and higher as well as signing officers. Shareholders may be included but only if they are active in the business and are part of a defined employee group that is larger than just the shareholders; otherwise, the premium is treated as a shareholder benefit.

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The tax treatment of a WLRP depends on the structure of the plan.

Where the policy is individually owned, the premiums paid are not deductible from income and the benefits received are not taxable. Where a corporation establishes a group disability plan (i.e. wage loss replacement plan) for its employees and pays the premiums, the premiums are deductible to the corporation but are not treated as a taxable benefit to the employees. However, the employees must pay tax on any benefits received under the plan. If premium costs are shared between the employees and the corporation, any benefits paid out are taxable to the extent they exceed the total premiums paid by the employee.

Structuring a Plan for Employees

A wage loss replacement plan provided by an employer can be structured in two ways. First, the corporation can increase the employee's salary to enable the employee to purchase his or her own coverage. This allows the employer to indirectly pay the employee's premiums, while still maintaining the tax-free status of the benefits. The increase in the employee's salary is taxable to the employee.

Alternately, the employer can pay the premium directly and report it as a taxable benefit to the employee. Once again, the tax-free status of any benefits paid to the employee is protected, while the premium paid by the employer is taxable to the employee.

These two structures are available only for employees. Shareholders who are employees are eligible for coverage but only in respect of their salary as an employee. These structures cannot be used for sole proprietors, partners, or non-employee shareholders.

Corporate-Owned Disability Insurance

An alternative approach to providing income in the event of disability is for the employer to purchase a disability insurance policy on the employee, which provides income to the employer in the event of a claim.

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There is no tax deduction for the premiums paid and the benefits received by the corporation are received tax-free. These funds can then be used to provide salary continuation payments to the disabled employee. These payments during a disability are deductible by the employer and taxable to the employee.

It should be noted that unlike life insurance, disability benefits received by a private corporation do not create a credit to the capital dividend account. As a result, such disability benefits cannot be flowed out to shareholders as a tax-free capital dividend.

Business Overhead Insurance

Business owners can also take advantage of **business overhead insurance**. This type of policy reimburses the business for its actual overhead expenses incurred while the business owner is disabled. Business overhead insurance premiums are deductible and any benefits received are taxable to the business.

Supplementary Health Insurance

Supplementary health insurance policies are designed to cover major medical expenses over and above the basic hospital and medical care provided by government-sponsored plans.

The premiums paid for individually-owned policies are not tax-deductible but qualify for the medical expense tax credit. The benefits received are tax-free, but the policy owner cannot claim any reimbursed expenses under the medical expense tax credit.

An incorporated employer can establish a **Private Health Services Plan (PHSP)** to reimburse employees or retirees for health expenses when all or substantially all (typically 90%) of the covered expenses qualify for the medical tax credit.

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In this case, employer contributions are deductible to the employer and non-taxable to the employee, and employee contributions qualify for the medical expense tax credit. As with individually-owned policies, the benefits received are tax-free but the policy owner cannot claim any reimbursed expenses under the medical expense tax credit.

Special rules apply to PHSPs for self-employed individuals such that they can deduct premiums paid for coverage up to a maximum of $1,500 for each of the self-employed individual, his or her spouse or partner, and any household member 18 years of age and older. A maximum deduction of $750 applies to household members under the age of 18. The dollar maximums are waived where full-time arm's-length employees represent at least 50 percent of the total number of self-employed individuals and full-time employees.

In order to qualify for this deduction, the individual must be a sole proprietor or partner in the business; and, either 50 percent of the individual's income must be derived from the business or income from other sources cannot be more than $10,000.

Critical Illness Insurance

Critical illness insurance is designed to provide a lump sum payment to an individual policy owner who is diagnosed with one of the illnesses covered under the policy. Increasingly, corporations are offering critical illness insurance to their employees as a group benefit.

The tax treatment of critical illness insurance is similar in some respects to that of disability insurance. Where the policy is individually-owned, the premiums paid are not deductible and do not qualify for the medical expense credit. The benefits received are not taxable.

Critical illness could also be corporate-owned, where the premiums are paid by the corporation and the benefits received by the corporation. Once again, there is no deduction for the premiums paid and the benefits received by the corporation are tax-free.

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These funds can be used to provide payments to the disabled employee, cover business expenses arising because of the employee's disability, or fund whatever expenses the business may choose. A payment to an employee would be deductible by the employer and taxable to the employee.

Critical illness benefits paid to a private corporation do not create a credit to the corporation's capital dividend account. As a result, such benefits cannot be paid out to shareholders as a tax-free capital dividend.

Some critical illness policies are designed with a Return of Premium (ROP) feature. If the policy is held until a predetermined date or until the death of the policy owner and no claims are made, the policy owner (or beneficiary) may be entitled to receive a refund of all the premiums paid. While most insurance companies do not tax report on the payment of an ROP either while the policy owner is alive or upon the owner's death, the tax treatment of such payment is unclear at this time. The ROP feature may preclude the policy from meeting the definition of a group sickness and accident insurance plan.

Long-Term Care Insurance

Long-term care insurance is designed to help cover the cost of long-term care when an individual is no longer able to care for him or herself. These expenses may include the cost of long-term care facilities or expenses arising from homecare assistance. While most people purchase this coverage privately, some employers are beginning to offer it as an employee benefit.

Long-term care insurance can be structured on a reimbursement or non-reimbursement basis. As the name suggests, **reimbursement policies** reimburse the policy owner for specific expenses on submission of receipts, usually up to a certain dollar maximum. **Non-reimbursement policies** usually pay a set dollar amount periodically regardless of whether costs are actually incurred.

Where long-term care policies are individually-owned, the premiums paid are not tax-deductible. However, they could qualify for the medical expense tax credit if the plan itself qualifies as a PHSP.

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To qualify, the plan must be structured on a reimbursement basis.

Any expenses that are not reimbursed are also eligible for the medical expense tax credit. If the plan is structured on a non-reimbursement basis, there is no tax relief for the premiums paid, but actual medical expenses incurred can be used to calculate the medical expense tax credit.

Where a corporation offers long-term care coverage as an employee benefit, premiums paid are deductible by the corporation and non-taxable to the employee, provided the plan meets the definition of a group sickness or accident insurance plan. If the plan is not considered a group plan, the premiums are treated as a taxable benefit to the employee.

In all cases, the benefits received from a long-term care policy are tax-free.

In addition to the base coverage, a **Return of Premium on Death (ROPD)** feature may be offered. However, the inclusion of this feature automatically bars the policy from qualifying as a PHSP and may preclude the policy from meeting the definition of a group sickness or accident insurance plan. For individually owned plans, the life insurance companies are not currently tax reporting on ROPD benefits. However, the tax treatment of such benefits is unclear at this time.

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Summary

After completing this module, you should have gained a solid understanding of:

- The taxation of life insurance products and its effect on the development of a suitable life insurance program;
- The tax implications of various annuity products as they are acquired to address financial and estate planning needs;
- The value of living benefits products and their tax implications in meeting clients' risk management needs;
- The use of mutual fund and segregated fund products to meet financial and estate planning objectives, particularly with respect to the income tax consequences on investment growth.

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Module 3: Income Splitting & the Taxation of Trusts & Beneficiaries

Learning Objectives

Upon completion of this module, you should be able to:

- Evaluate, synthesize, and recommend income splitting strategies and techniques with respect to client-specific situations while integrating the principles of attribution;
- Evaluate, synthesize, and recommend the appropriate use of inter vivos and testamentary trusts to suit a client's circumstances;
- Explain the application of taxation as it applies to trusts, including the issue of residency.

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Income Splitting

The marginal tax rate system in Canada often motivates taxpayers to shift income from a higher earner to a lower-income person within a family unit. The overall effect is to increase the family's disposable income by lowering the overall tax bill. These types of arrangements are commonly referred to as income splitting. There are a significant number of rules within the ITA to prevent income splitting, particularly in non-arm's-length situations. In addition, there are anti-avoidance rules designed to neutralize the impact.

Income Splitting Overview

Income splitting is the transfer of income or income-producing property from a high-income family member to a lower-income family member with the objective of reducing the family unit's overall tax burden.

Canada's use of the **marginal tax bracket system** means members within a family unit are often in different tax brackets – some higher and some lower. Through the concept of income splitting, income is shifted from an individual in a higher tax bracket to a family member in a lower tax bracket, resulting in the family's total tax bill being lower than if no income splitting occurred. Pension income splitting is an example of a government-sanctioned strategy that allows a select group of married and common-law couples to move income between brackets for a more favourable outcome. The reason for pension income splitting is purely tax-motivated.

Federal Income Tax Brackets (2018)	
Taxable Income	**Federal Tax Rate**
0 to $43,953	15%
Over $43,954 to $93,208	20.5%
Over $93,208 to $144,489	26%
Over $144,489 to $205,842	29%
Over $205,842	33%

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Beyond tax-bracket management, income splitting may also impact tax credits. For example, an age credit is available to Canadians 65 years of age and older; however, there is a schedule for clawing back. In 2019, the amount on which the age credit is based is $7,494, which is reduced at the rate 15 percent for net income in excess of $37,790. As such, the full credit is valued at $1,124 (15 percent x $7,494) on the federal portion of income taxes owing. Income splitting can be helpful as a transferring spouse could lessen the impact of the age credit reduction.

However, the attribution rules and anti-avoidance rules in the ITA prevent certain forms of income splitting. In simple terms, attribution rules within the ITA require that income earned and capital gains realized on transferred property be attributed back to the original family member for tax purposes. The spirit of the anti-avoidance rules is to negate the possibility of income splitting under pre-defined circumstances by denying the shift.

This segment will look at income splitting opportunities with a discussion of attribution rules to follow.

Income Splitting with a Spouse

There are many strategies for **income splitting with a spouse;** the following are several that will be discussed in this section.

- Prescribed rate loans;
- Second-generation investment income;
- CPP/QPP benefit sharing;
- Pension income splitting;
- TFSA income splitting;
- Spousal RRSPs; and,
- Income splitting through salaries paid for employment in a family business.

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Prescribed Rate Loan

One method of income splitting between family members is for the higher-income family member to lend capital to a lower-income family member. As stated in subsection 74.5(2), if a loan bears interest of at least the prescribed rate, and the interest is paid within 30 days after year-end, the attribution rules do not apply. The interest rate on the loan must be based on the applicable rates at the time the loan is established, and the terms of the loan agreement must be fully documented in writing.

It does not matter if the loan is between spouses or a parent and child. Similarly, a grandparent and grandchild can avoid attribution through the use of a **prescribed rate loan**.

Another option could be the use of a **family trust**. A discretionary family trust could be used to receive the loan from the higher-income family member and all of the lower-income family members could be beneficiaries. A trust may be preferred as a form of control such that the children do not have direct access to the investment capital, only the investment income allocated to them.

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EXAMPLE

Jill, a high-income earner, lends money to her lower-income-earning husband, Jack, to invest. To meet the prescribed rate loan requirements, Jack must pay interest to Jill and Jill must claim the interest received as income. Jack will realize any income earned or capital gains realized on the capital he has borrowed from Jill. He is entitled to deduct the interest paid to Jill because the borrowed funds were utilized to earn income. The following summary outlines the overall effect using a 2 percent prescribed rate.

	Jill	Jack
Current Situation		
Invested capital	$1,000,000	Zero
Taxable income from investments	$80,000	
Estimated taxes thereon (40%)	$32,000	
Total taxes paid	$32,000	
Prescribed Rate Loan		
Loan to Jack	$1,000,000	$1,000,000
Taxable income from investments		$80,000
Interest income / (expense)	$20,000	($20,000)
Estimated taxes thereon (45% / 20%)	$9,000	$12,000
Total taxes paid	$21,000	
Taxes saved	$11,000	

It is important to note that Jack must pay the interest of $20,000 to Jill by January 30th of the following year. Failure to pay the interest will result in Jack's investment income being allocated back to Jill and taxable to her (income and capital gains attribution 74.1(1) and 74.2(1), respectively). As well, it is important to officially document the terms of the loan in a written agreement.

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Prescribed Interest Rates [15]

The Canadian government uses an interest rate referred to as the "**prescribed rate**" to establish the interest rate charged to taxpayers when they have overdue taxes and when interest is paid by the government to taxpayers on tax over- payments/refunds. In addition, the prescribed interest rate is used as the minimum interest rate taxpayers must apply to avoid certain taxable benefits.

The prescribed interest rate is calculated as the average rate of treasury bills sold with a three-month duration during the first month of the previous quarter (i.e. October 2018 for the first quarter of 2019), and rounded to the next highest whole percentage point. This means that the information for the prescribed rate is known two months in advance.

The table below shows that the prescribed rate of interest for the past three years plus the first quarter of 2019. The prescribed rate was running at one percent for each quarter of 2016 through to the first quarter in 2018. Beginning in the second quarter of 2018, the prescribed rate increased to two percent and has remained unchanged as shown in the chart below.

Prescribed Interest Rates				
Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2019	2%			
2018	1%	2%	2%	2%
2017	1%	1%	1%	1%
2016	1%	1%	1%	1%

Calculation of the precise interest rate charged or paid by the government begins with the prescribed rate followed by a plus, minus or no change, as follows:

- The interest rate charged on under-payments of taxes by any taxpayer is four percentage points above the prescribed interest rate;
- The interest rate paid on over-payments of taxes by individuals and trusts is two percentage points above the prescribed interest rate;

[15] Updated excerpt from *Comment, Edition 283, January/February 2014*

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- The interest rate paid on over-payments of taxes by corporate taxpayers is the prescribed interest rate.
- The interest rate charged to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans is the prescribed interest rate.

This means that for the first quarter of 2019, the following rates will apply:

- Taxpayers will pay 6 percent interest when taxes are overdue (2 percent prescribed rate plus 4 percent).
- The government will pay 4 percent interest to individuals and trusts who have overpaid taxes owing (2 percent prescribed rate plus 2 percent).
- The government will pay 2 percent interest to corporate taxpayers who have overpaid taxes owing (2 percent prescribed rate).
- The government will apply a 2 percent interest rate when calculating the taxable benefits for employees and shareholders from interest-free and low-interest loans (2 percent prescribed rate).

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Second-Generation Investment Income

There are no attribution rules that apply to investment income earnings on second-generation income as it relates to transfers and loans between spouses or common-law partners. So, another income splitting strategy is to carefully segment all investment income earned and reinvest the earnings separately so that attribution does not apply to the second-generation earnings. This is not necessarily the case for second-generation income that falls within the tax on split income rules, which will be discussed in a subsequent section.

EXAMPLE

Wilma lends $500,000 to Fred for him to begin an investment account. Wilma knows that the first generation of investment income will be allocated to her, but her objective is to assist Fred in building his own base of capital compromised of first- and second-generation investment income.

	Wilma	Fred
Investment income earned in the first year paid to Fred but taxed to Wilma	$40,000	
Investment income in the second year on the original capital earned by Fred but taxed to Wilma	$40,000	
Investment income in the second year on investment income paid to Fred		$3,200
Investment income in the third year on the original capital earned by Fred but taxed to Wilma	$40,000	
Investment income in the third year on investment income paid to Fred		$6,656

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CPP/QPP Pension Benefit Sharing

Spouses and common-law partners who are both at least 60 years old and are both receiving a Canada Pension Plan (CPP) retirement pension can share the portion of their pension benefits earned during the term of their marriage or common-law partnership. The total dollar amount of CPP benefits paid does not change with CPP sharing; instead, sharing adjusts the amount of monthly CPP benefit each spouse or partner receives from the CPP. The CPP retirement benefit is split at source, with the **split benefit** paid to each spouse. While the receiving party is liable for income taxes on the amount received, the amount of tax withholding at source on the original pension payments is split in the same proportion as the pension income.

Couples would only elect to share their CPP/QPP retirement benefit if there was a benefit to them in terms of tax savings.

If only one spouse or partner is a CPP contributor, the couple can share the single CPP pension.

EXAMPLE

Ken and Dianne have been married since 1979. They are both over the age 60 and both receive a CPP retirement pension. Ken's monthly retirement pension totals $400. Of this income, $100 is based on the income he earned before he and Dianne married; this $100 is not eligible for pension sharing. The remaining $300 of CPP benefit is based on income Ken earned during their marriage. Because Dianne did not work before she married Ken, her entire CPP entitlement of $550 is based on the income earned while married to Ken.

In total, Ken and Dianne's CPP entitlement is $950 ($400 + $550). After deducting the $100 of Ken's entitlement that was earned before his marriage to Dianne, the net shareable CPP is $850.

If Ken and Dianne elect to pension share, they will each receive 50 percent of $850, or $425. Ken will also receive the $100 based on his pre-marriage earnings for a total of $525. Total CPP earnings for both therefore are $525 for Ken and $425 for Dianne.

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Cancelling Pension Sharing

Pension sharing can be cancelled if both spouses/partners agree. For spouses, sharing ends on a separation or divorce or the death of one spouse. For common-law partners, the arrangement ends on the death of one of the partners or if both partners request that it be cancelled.

Québec Pension Plan (QPP)

The **Québec Pension Plan (QPP)** also has a provision for pension sharing but with different eligibility requirements. Further, spouses/partners can pension share across CPP/QPP (i.e. where one spouse/partner receives CPP benefits and the other receives QPP benefits); eligibility is based on the rules for each plan.

Pension Splitting

Any Canadian resident who receives income that qualifies for the pension income tax credit can allocate up to half of this income to his or her resident spouse/common-law partner. The rules governing the type of pension income that qualifies for income splitting mirror the rules governing eligibility for the $2,000 pension income credit.

Because the **split pension income** being transferred increases the transferee's own tax payable, both spouses/partners must specifically agree to the allocation in their tax returns for the year. Both the agreement and the amount can be changed from year to year.

The transferred pension income retains its character in the hands of the transferee spouse/partner for all purposes. This has several specific benefits:

- Ability for each spouse to claim the $2,000 pension income credit;
- Potential ability to avoid OAS clawback for some higher-income pensioners; and,
- Overall tax savings.

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Aged 65 & Older

For clients aged 65 years and older at the end of the year, the main types of qualifying pension income that can be transferred to a spouse/partner's return include:

1. A life annuity payment from a registered pension plan;
2. An annuity payment under a registered retirement savings plan;
3. A payment under a registered retirement income fund;
4. A payment from a pooled registered pension plan;
5. An annuity or installment payment from a deferred profit sharing plan;
6. The taxable portion of a non-registered annuity payment; and,
7. Income reported from a non-exempt life insurance policy.

Under Age 65

For clients under age 65, the list is far more restrictive and includes:

1. A life annuity payment from a registered pension plan;
2. Any of points two to seven above received as a consequence of the death of a spouse or common-law partner.

Other Notes

The age of the receiving spouse does not matter with respect pension splitting. As long as one spouse has qualifying pension income that can be split, the age of the other spouse is not taken into account.

Types of income that specifically do not qualify for pension splitting include the following:

- Old Age Security (OAS);
- Guaranteed Income Supplement (GIS);
- CPP/QPP; and,
- RRSP withdrawals (non-annuity).

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CPP Sharing

Note that while technically CPP income does not qualify for the pension splitting rules, spouses and partners who are both at least 60 years of age can still share up to half of their CPP retirement benefit through the CPP program directly. (See CPP/QPP Sharing).

Benefits of Pension Splitting

One of the primary benefits of pension splitting is to lower the couple's overall income tax liability. By shifting income, one or more of the following benefits might be achieved:

- The receiving spouse may be able to claim the pension income tax credit;
- The transferring spouse may be able to lower his or her net income enough to reduce the impact of the OAS clawback;
- The transferring spouse may be able to lower net income enough to reduce the impact of the old age credit reduction; and,
- The transferring spouse may be able to lower taxable income below the next tax bracket, allowing for the retention of more income.

EXAMPLE

Harvey, age 65, decides to split his RRIF withdrawals with his wife, Lisa, who is 62. While Harvey is eligible for the pension income credit resulting from his RRIF withdrawals, the allocated amount will not qualify for a credit in Lisa's hands because she is not yet 65.

On the other hand, if Harvey were receiving a monthly income from a pension plan, the income would automatically qualify for the pension credit in both Harvey and Lisa's hands, regardless of their ages.

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OAS Clawback

OAS is clawed back at a rate of 15 percent. The beginning threshold for the clawback in 2018 was $75,910 (2019 amount is $77,580). In 2018, the upper threshold for clawback was $123,386, so those who exceeded this upper limit were not eligible for the OAS benefit. The 2019 upper income limit is not available at the time of writing because OAS changes quarterly.

The pension income splitting rules can be helpful to seniors who are affected by the OAS clawback as it allows them to shift some pension income to the lower-income spouse/partner and avoid (or reduce) the clawback. This presents a significant opportunity, even if the taxpayer's spouse or common-law partner is in a similar tax bracket.

EXAMPLE

Mario and Sally both have a 22 percent average tax rate. Mario's total net income is $80,000 and Sally's is about $50,000. Mario's qualifying pension income is $20,000. If Mario elects to allocate half his pension income ($10,000) to Sally, they will both be below the OAS income clawback threshold. As a result, Mario will protect all of his OAS from the clawback.

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Death of a Spouse

If one spouse dies during the year, pension income can be split according to a formula that takes into account the length of time during the year that the couples were still married (i.e. before the deceased spouse's death).

EXAMPLE

Adam dies at the end of September of 2019. During the 2019 taxation year, his wife, Eve, received pension income. She and Adam's executor want to split this pension income (between Eve and Adam's terminal return) for tax purposes. In these circumstances, the CRA allows the parties to split a maximum of 50 percent of the eligible pension income pro-rated by the number of months during which the couple was married. In this case, the maximum amount eligible is nine-twelfths of 50 percent of the pension income, because Adam and Eve were married for nine months in 2019.

This split income must be included in Adam's final tax return. Adam's executor and Eve must complete Form T1032 (to elect to split the eligible pension income) and file it with each of their respective 2019 tax returns.

This notional split is accomplished by electing in each spouse/partner's tax return the amount to be deducted from the income of the person receiving the pension and included in the income of the spouse/partner. The spouse being allocated the split income is responsible for the income tax consequences. The spouse allocating the split income will be entitled to a deduction for the income allocated and retains legal title to the actual income that was split. The election is made using the CRA Form T1032, Joint Election to Split Pension Income.

TFSA Income Splitting

Contributions to a spouse or common-law partner's TFSA are not subject to attribution, nor are investment earnings on assets held within the plan. This differs from a spousal RRSP, which applies attribution based on the timing of contributions and withdrawals.

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This exemption provides a significant opportunity for a high-income spouse or common-law partner to contribute the maximum to a lower-income spouse or common-law partner’s TFSA and benefit from income splitting.

Spousal RRSPs[16]

Spousal RRSPs are another form of income splitting. The higher-income spouse contributes into an RRSP in the name of the lower-income spouse. The contributing spouse is entitled to the RRSP deduction and uses up his or her personal contribution room. The annuitant spouse benefits from the additional assets held within his or her RRSP, as it is eventually used to create retirement income, which is taxed in the lower-income spouse’s hands.

There is an attribution rule (subsection 146(8.3)) that says if the annuitant spouse draws money out of any spousal RRSP, the contributing spouse is taxed on the withdrawal up to the amount contributed into a spousal RRSP in the current or prior two years.

Two exceptions to this attribution rule are:

- Income received from a registered annuity is not taxed back to the originating spouse; and,
- RRIF minimum payments are not attributed back to the originating spouse. Amounts withdrawn above the RRIF minimum are subject to attribution.

The annuitant spouse is taxed on the difference between the total withdrawal and the amount attributed to the contributing spouse.

Note that attribution does not apply if the partners are living apart because of marriage breakdown, if the contributor died during the year, or if either the contributor or the annuitant is not resident in Canada at the time of payment.

[16] Discussion is taken from *Comment, Edition 286, July/August 2014*

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EXAMPLE

In 2014, Hanna and Harold were planning for their retirement. Projections suggested that Hanna's retirement income would be much higher than Harold's income. It was suggested that Hanna shift her RRSP contributions into a spousal RRSP. Beginning immediately in 2014, Hannah made $5,000 deposits annually into a spousal RRSP.

In 2019, Harold withdraws $25,000 from his spousal RRSP (he is the annuitant and Hanna is the contributor) in order to buy an electric car as a surprise birthday gift for Hanna.

Attribution to Hanna	$15,000	Hanna's deposits into a spousal RRSP in the current year ($5,000) and prior two taxation years ($5,000 x 2).
Taxable to Harold	$10,000	$25,000 withdrawn less $15,000 attributed to Hanna.

A spousal RRSP may have a little more flexibility than pension splitting in that income from a spousal RRSP can begin earlier than the pension-splitting age. In addition, income from a spousal RRSP could be higher than that allowed under the pension-splitting rules.

Income Splitting Through Family Business

There are limited opportunities to split income between spouses when one is a shareholder of a private corporation and the other is not.

Salary

A salary could be paid to the shareholder's spouse for work performed in the business. Caution has to be exercised to ensure the payment is reasonable and relates to work with a clear business purpose. Otherwise, there is the strong possibility the CRA could deny the deduction and consider such payments to be a shareholder benefit, creating a double-tax outcome.

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A benefit of hiring family members to work in a business is the opportunity to effectively split incomes within a household. This can be done whether the business is incorporated or run as a proprietorship. However, similar to the situation above, there needs to be real work performed and the amount paid must be reasonable. Reasonable typically equates to an amount that would have been paid to non-related parties.

EXAMPLE

An accountant with annual revenue of $55,000 was successful in deducting $34,500 paid to his spouse to handle the administration of his business. The Court found that "many professionals and businessmen make less money from their businesses than their secretaries do" and concluded that the arrangement was "a common and reasonable business deal."

Dividends

In very general terms, a spouse who is actively involved in a business on a full-time basis during the year could receive dividends on the shares he or she holds without causing the adverse tax consequences arising from the TOSI rules. Similarly, if the spouse has worked full-time in the business for at least five years, not necessarily continuously, the dividend could also be received without causing TOSI consequences.

If however, a spouse who is not actively involved in the business operations during the year when a dividend is received or has not met the five-year employment threshold noted above, the TOSI rules may apply unless the spouse qualifies under one of the TOSI exception rules. The exception rules are complex and will be discussed in the subsequent section on anti-avoidance.

A more fulsome discussion of the TOSI rules in a subsequent section will provide additional context and demonstrate income splitting through private companies is extremely restrictive.

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Other Family Members

Income splitting with other family members, such as children or siblings, may be available under very limited circumstances. As discussed in the previous section, the reasons for income splitting is to leverage the benefit of another family member's lower tax bracket.

Many of the income splitting strategies for spouses can be replicated for other family members. The three main areas are:

- Prescribed rate loans;
- Capital gains;
- Second-generation investment income;
- TFSA income splitting; and,
- Income splitting through salaries paid for employment in a family business.

Prescribed Rate Loan

A prescribed loan to a discretionary family trust can work well in many family situations. The income earned within the trust can be allocated to the beneficiaries with the greatest need. The principle investment is kept under the control of the trustee. The capital can be repatriated by calling the loan. The availability of the today's low prescribed-rate loans makes this strategy less desirable and would probably only be used if the prescribed-rate loan fails because interest was not paid within 30 days of year-end.

Prescribed rate loans can also be made directly to adult family members such as children, sibling, parents and grandparents.

Capital Gains

Gifts and zero-interest loans to minor children will trigger an income attribution rule.

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With respect to adult children, zero-interest loans for the purpose of income splitting will cause the income attribution rules to apply. However, capital gains earned by the child on gifts or zero-interest loans are not attributed back to the first party.

EXAMPLE

Frank lends his adult daughter, Frida, $100,000 but does not charge her nay interest on the loan. The intention of the loan is to shift income earnings to Frida and lower the family's overall tax bill. In the first year, Frida earns $2,000 of interest, $1,5000 of taxable dividends, and $3,000 of capital gains.

The $2,000 of interest income and $1,500 of taxable dividends would be attributed from Frida back to Frank.

The $3,000 of capital gains would be taxable to Frida.

Tax-Free Savings Account

Parents may also consider gifting an amount equal to the available TFSA contribution limit to any of their children who are 18 years of age or older. The gift would then be contributed into a **Tax-Free Savings Account (TFSA)** in the adult child's name. (A TFSA cannot be set up in trust for a child).

Income Splitting Through Employment in a Family Business

Employing family members in a private business provides the opportunity to pay salaries to those family members for the actual work performed. Salary is reported as employment income to the recipient and is deductible to the business. Any payments should reflect amounts that are reasonable in the circumstances.

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EXAMPLE 1

In 2005, a commissioned insurance advisor tried to deduct the cost of salaries he paid to his five children for various office duties, including filing, telemarketing, banking, data entry, and attending cultural events to obtain business. The CRA disallowed the advisor's claim. At a subsequent hearing, the judge questioned why so many employees were needed to work so many hours to carry out the tasks. Based on the testimony that the children did some work for the advisor, the Court allowed 50 percent of the salaries to be claimed as deductible business expenses.

EXAMPLE 2

In another 2005 case, the court allowed an entrepreneur to deduct $7,000 paid to each of his two sons, aged 11 and 13, for photocopying and stuffing envelopes for five different mailings during the year. The entrepreneur was able to demonstrate that the time worked was over 600 hours per child and the salaries were determined to be fair.

Attribution

The **attribution** rules in the ITA prevent certain forms of income splitting in pre-defined non-arm's-length situations.

Attribution rules require income and capital gains under certain non-arm's-length circumstances are attributed back to original taxpayer.

Attribution Rules

The **attribution rules** seek to move income back to the originating party in an income splitting arrangement.

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This usually means the higher-income family member ends up with the income that was being split with the lower-income family member.

Income is attributed back to the transferor on property transferred to a spouse or minor child as outlined in the following provisions.

- Attribution of income to spouse, subsection 74.1(1);
- Attribution of income to minor child, subsection 74.1(2);
- Guarantees deemed to be the same as a loan, subsection 74.5(7).

Capital gains are attributed back to the transferor on property transferred to a spouse, as outlined in the following provision.

- Attribution of capital gains to spouse, subsection 74.2(1).

Transfers, zero-rate loans, and loan guarantees are all transactions that can trigger the attribution of income and maybe capital gains generated on the capital, as outlined in the following provisions.

- Transfers and zero-rate loans, subsection 74.1, 74.2, and 74.3;
- Loan guarantees, subsection 74.5(7).

EXAMPLE

Ben guarantees a $100,000 investment loan being extended to his common-law partner, Barry. Barry invested the capital and generated $1,000 of interest income, $2,000 of dividend income and $1,000 of realized capital gains and the $2,000 of accrued capital gains.

Ben will have to report $1,000 of interest income, $2,000 of dividend income, and $1,000 of capital gains attributed from Barry to himself. The unrealized capital is not taxable until realized.

EXAMPLE

Ben lends $100,000 without interest to his 31-year-old son, Bert, with the purpose of shifting income. Bert invested the capital and generated $1,000 of interest income and $2,000 of dividend income attributed from Bert to himself. The realized capital gain is not subject to attribution.

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EXAMPLE

Ben gives $100,000 to his son, Brian, who just turned 16 years of age. Brian invested the capital and generated $1,000 of interest income, $2,000 of dividend income and $1,000 of realized capital gains and $2,000 of accrued capital gains.

Ben will have to report $1,000 of interest income and $2,000 of dividend income attributed from Brian to himself. The realized capital gain is not subject to attribution.

The primary exception to the attribution of income and capital gains in this example is the existence of market-driven loans between the parties. The criteria for a loan for value is that the interest is equal to or greater than the prescribed interest rate at the time the loan is granted and the interest is paid within 30 days of calendar year-end. The prescribed interest loan was described in Income Splitting with a Spouse.

Anti-Avoidance Rules

The anti-avoidance rule in the ITA prevents certain forms of income splitting in pre-defined non-arm's-length situations.

Anti-avoidance rules are penalty provisions designed to penalize one or both of the parties involved in certain transactions. There is often a high-tax cost associated with the outcome. The two main anti-avoidance provisions include:

- Corporate attribution; and,
- Tax on split income.

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Corporate Attribution

Corporate attribution, defined in section 74.4 of the ITA, is designed to discourage income splitting with family members. In simple terms, it occurs when an individual resident in Canada, transfers or lends property to a corporation (other than a small business corporation) and one of the main reasons is to reduce his or her income and benefit a designated person who is specified shareholder.

When these circumstances apply, the individual is assessed an interest benefit based on the value of the property transferred and the current prescribed interest rate, to the extent that calculated interest benefit exceeds any interest or dividends received in respect of the property transferred.

Definitions to help with the understanding of corporate attribution include:

- A **small business corporation** is a Canadian-controlled private corporation where all or substantially all of the FMV of its assets is attributable to an active business carried on primarily in Canada. "All or substantially all" has been interpreted by the CRA to mean 90% or more.
- A **designated person** is a spouse or common-law partner of the individual, or someone under the age of 18 who either does not deal at arm's-length with the individual (e.g., a child), or is a niece or nephew of the individual.
- A **specified shareholder** is an individual who owns 10 percent or more of the issued shares of a class of shares of the corporation.

Application of the corporate attribution rule can arise very innocently and in almost any estate freeze corporate reorganization implemented for an individual. During such a reorganization, an individual taxpayer will often transfer his or her shares into a new holding company and take back fixed-value preferred shares. New common shares will be issued directly to the family (i.e., spouse and children), or indirectly to a trust on behalf of the family. One reason for an estate freeze is to create the ability to split income and multiply the capital gains exemption.

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However, the stage is now set for the corporate attribution rule to apply, because the individual has transferred property and one of the main reasons was to reduce income and benefit one or more "designated persons."

The corporate attribution rule does not apply when the corporation is a small business corporation. Therefore, the simplest means of avoiding the interest benefit is to ensure the corporation meets the requirements of a small business corporation when the transaction occurs and remains so afterwards. However, maintaining such a status can be difficult during the ownership of the active operations and becomes increasingly difficult after the active operations have been sold. The attribution rule will apply to investment corporations or any corporation that primarily earns passive income.

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EXAMPLE

Dwayne reorganizes the family business by exchanging his common shares valued at $2,000,000, for $2,000,000 of fixed value, redeemable, and retractable preferred shares. A discretionary family trust subscribes to the company's common shares. The beneficiaries of the family trust are Dwayne's spouse and their children.

On January 1, 2019, 15 years after the reorganization noted above, Dwayne causes the family business to sell all of its assets and he re-invests the after-tax proceeds in the company. The company is no longer a small business corporation.

Dwayne will have to recognize $40,000 (i.e., prescribed rate of 2 percent times $2,000,000, assuming that the prescribed rate stays at 2% for all quarters of 2019) of income on his 2019 tax return in respect of the corporate attribution rule.

If Dwayne had received $10,000 worth of dividends on his fixed-value preferred shares, the taxable amount would have been $11,600 (i.e., 16 percent gross-up for ineligible dividends, 2019 amount); then his income inclusion pursuant to the corporate attribution rule would be $28,400 (i.e., $40,000 less $11,600).

During the period Dwayne's company maintained its status as a small business corporation, Dwayne was not subject to the corporate attribution rule. Once the company's active assets were sold, it no longer qualified as a small business corporation and the corporate attribution rules could apply.

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Tax on Split Income[17]

Since the 2000 taxation year, certain income earned by a minor (under age 18) has been subject to a special income splitting tax. Effective for 2018 and subsequent years, the tax on split income (TOSI) rules have been expanded to eliminate income splitting with related individuals, regardless of age, who have not contributed significantly to the business. This change means that higher taxes could apply to dividends and interest paid from privately held corporations to its shareholders and other individuals related to the shareholders. Some capital gains could also be caught.

The complexity of the TOSI rules and their application will create challenges for taxpayers and their professional advisors as everyone begins to interpret and apply the expanded rules to their specific circumstances. Even the CRA has indicated their approach to applying the rules will evolve over time based on their experience and assessment of whether their approach is addressing the tax policy concerns underlying the new rules.

The Department of Finance suggests that where a family member is significantly involved and making a meaningful contribution to a business, the theory is that the individual should be excluded from the new tax on split income rules. They also suggest that about 3 percent of Canadian-controlled private corporations, which is approximately 45,000 entities, will be affected by these changes. The challenge is translating the theory into practical terms, which requires an understanding of a series of definitions and the application of the concept of meaningful contribution. Included in the new rules is the phrase "directly and indirectly," which widens the breadth of circumstances subject to TOSI.

[17] Adapted from COMMENT, March/April 2018

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The Broad TOSI Rules

In simple terms, the TOSI rules are designed to apply in all circumstances where a dividend or interest is paid and capital gains are realized in respect of a private corporation, unless the circumstances fall within two types of exceptions – definitive and subjective exceptions. The definitive exceptions are clear and can be easily ascertained.

The subjective exceptions are far more difficult to ascertain and are based on an assessment of the facts associated with each set of circumstances.

Income meeting the definition of TOSI is removed from the individual’s net income and taxed separately at the top marginal tax bracket in his or her province of residence. In addition to paying tax at the top tax rate, the individual may claim only the dividend tax credit, tax credit for mental or physical impairment and foreign tax deduction. As such, there is limited opportunity to offset the tax consequences arising from TOSI using personal tax credits.

For individuals under the age of 17 before the year begins, split income also includes capital gains realized by the individual on the disposition of shares of a private company to persons who are non-arm’s-length to the individual. These gains are brought into the definition of split income by deeming such gains to be taxable dividends from the private company. This deeming rule re-characterizes a capital gain into a dividend, which means minors cannot claim their capital gains exemption because they did not realize a capital gain.

There are numerous terms and definitions explained throughout this section because understanding these terms is necessary when applying the TOSI rules and the exceptions.

The term 'Related Business' is used throughout the TOSI rules. In general, a '**Related Business**' with respect to an individual (Tom) is a corporation where Tom is related to another individual (Alice) who owns shares of the corporation (Opco) and those shares represent 10% or more of the FMV of the Opco shares. In other words, if Alice and Tom are related (e.g. spouses, common-law partners, parent and child, siblings, etc.) and Alice is a 10% (or more) shareholder of Opco, then Opco is a 'Related Business' to Tom.

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In addition, a 'Related Business' in respect of an individual (Shera) could also include a business of a sole proprietorship, corporation, partnership or trust where an individual (Daniel) who is related to Shera is actively engaged in the operation of the business.

Exceptions Where TOSI Will Not Apply

As noted above, the TOSI rules apply broadly. In simple terms, to escape from the new higher tax consequences that arise, an individual and the amount that the individual receives must fall within an exception under the TOSI rules. Some of these exceptions are examined below:

a) Excluded Business Exception

Individuals, aged 18 and over, who contribute labour to a 'Related Business' on a regular, continuous and substantial basis are considered to be '**Actively Engaged**' and are not subject to TOSI.

The rules provide that an individual is deemed to be Actively Engaged' if the individual works in the business at least an average of 20 hours per week during the taxation year or meets this requirement in any five prior years. The five prior years do not need to be consecutive. For seasonal businesses, the average of 20 hours per week will be measured during the period the business operates in the relevant taxation year.

The 20-hour criteria is a definitive rule that can be easily determined. In any other circumstances, determination of whether the individual is 'Actively Engaged' will depend on the facts and circumstances of each case. The considerations used to determine whether an individual is 'Actively Engaged' from a subjective perspective is similar to the criteria utilized when analyzing the 'Reasonable Return' exception, which is discussed in a subsequent section.

Individuals who meet the definitive 20-hour exception will not be subject to the TOSI rules for amounts received from a 'Related Business' because the amounts will be considered an 'excluded amount.'

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In addition, when individuals fall within the definitive exception, they do not need to consider the TOSI rules with respect to whether the amounts received were reasonable.

b) Excluded Share Exception

Individuals ages 25 and over who own an 'Excluded Share' of a corporation are not subject to TOSI.

For a share to be considered an '**Excluded Share**,' four criteria must be met:

- less than 90% of the corporation's business income was from the provision of services;
- the corporation is not a professional corporation;
- the shares held by the individual represent 10% or more of the votes and value of the corporation; and,
- all or substantially all of the income of the corporation is not derived from another 'Related Business' in respect of the individual.

c) Reasonable Return

Individuals age 25 and over who receive an amount that qualifies as a 'Reasonable Return' are not subject to TOSI. The determination of a '**Reasonable Return**' is based on one or more of the following 'Reasonableness Criteria,' as outlined below:

1. *Labour Contribution* - the work performed by the individual in support of the Related Business before the amounts became paid.
2. *Property Contribution* - the property contributed directly or indirectly by the individual in support of the Related Business.
3. *Risk Incurred* - the risks assumed by the individual in respect of the Related Business.
4. *Historical Payments* - the total amounts paid or payable by any person or partnership to or for the benefit of the individual in respect of the Related Business.

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5. *Other factors* that may be relevant. See Figure One, Factor Review, for more details under each of these major categories that the CRA has indicated may be considered in their analysis of 'Reasonable Return.' This analysis is subjective in nature and will be applied based on the facts specific to each situation. As such, while taxpayers may do their own analysis, it will not be a definitive outcome and may be subject to CRA scrutiny.

d) The greater of a Safe Harbour Capital Return and Reasonable Return based on the cost of Arm's Length Capital

Individuals over age 17 and less than age 24 before the year who receive a return on property contributed in support of the 'Related Business' will not be subject to TOSI on that amount provided that such return does not exceed the greater of a prescribed capital return and a reasonable return based on the contribution of arm's length capital. The prescribed rate is used in determining the **safe harbour capital return**.

e) Other Exceptions

TOSI does not apply in the following circumstances:

- When an individual under age 24 before the year begins has income or capital gains in respect of property acquired as a consequence of:
  - the death of their parent; or,
  - the death of any person if the individual is enrolled as a full-time student at a post-secondary educational institution or qualifies for the federal tax credit for mental or physical impairment.
  - when an individual acquires property from a spouse or common-law partner pursuant to a decree, judgement or written separation agreement.
  - when a deemed disposition occurs on death.

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Below is a summary of other circumstances where TOSI will generally not apply.

- Dividends or profits received by an individual if their spouse has attained age 64 before the taxation year and the amount would have been an excluded amount, as outlined in the exceptions above, if paid to the recipient's spouse. The suggested rationale for this exclusion is to provide business owners with an income sharing opportunity that parallels pension income splitting afforded to other similar aged individuals.
- Capital gains arising as a result of dispositions, by individuals over age 17 of qualified farm or fishing property or shares of a qualified small business corporation.
- Salary and wages paid to related family members. However, salary and wages may be a consideration if a TOSI reasonableness analysis applies to other types of payments made to that individual. In addition, salary and wages are already subject to reasonableness tests in order to be a deductible expense of the business.

Amounts received by an individual living separate and apart from their spouse or common-law partner because of a breakdown of their marriage or common-law partnership are generally excluded.

Application of the TOSI Rules

The following are three examples that will help provide guidance in the application of the TOSI rules. In all examples, assume that the taxpayers are residents of Canada. The examples have been developed using straightforward facts as outlined. Changing or adding facts beyond what is noted could change the outcomes.

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EXAMPLE ONE

Assume the following facts:

- Opco carries on an active business that is neither a service business nor a professional corporation. Ailin founded Opco several years ago and her eldest child, Sarah, is now active full-time on the management team at Opco. No one else in the family works or has ever worked at Opco.
- The shareholders of Opco are Ailin and a discretionary family trust. Beneficiaries of the trust are Alex (Ailin's spouse), Sarah, and Ailin's son, Johnny, along with four grandchildren under the age of 18. Sarah and Johnny are both over age 24.
- Ailin owns 1,000 fixed-value preferred shares that carry one vote each and are worth about half of the value of the business.
- The trust owns 1,000 common shares that carry one vote each and would be worth about half of the value of the business.

The plan is to systematically redeem Ailin's fixed-value preferred shares, pay Sarah a salary and pay a dividend to the discretionary family trust, which will be allocated equally to Sarah and Johnny.

The deemed dividend realized by Ailin on the redemption of her fixed-value preferred shares will be an excluded amount because of the 'Excluded Business' and 'Excluded Share' exceptions. Ailin is 'Actively Engaged' in the business which means the income meets the 'Excluded Business' exception. As well, the shares that Ailin owns meet the definition of an 'Excluded Share' (at least 10% of the votes and value).

The dividend allocated to Sarah will be considered an excluded amount under the 'Excluded Business' exception because Sarah is 'Actively Engaged' in the business.

The dividend allocated to Johnny does not fall within any of the exceptions under the TOSI rules. Johnny is not currently and has never been 'Actively Engaged' in the business so does not meet the 'Excluded Business' exception. He does not own shares of Opco so does not meet the 'Excluded Share' exception. The payment to Johnny does not meet the criteria for a 'Reasonable Return' when applying the reasonableness criteria to the fact situation. The outcome of this payment to Johnny is that the dividend will be taxed at the top marginal tax rate.

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In summary, Ailin and Sarah's dividends will not be subject to TOSI but Johnny's dividend will be.

EXAMPLE

Assume the following facts:

- Opco carries on an active business of farming and is neither a service business nor a professional corporation. Opco is a seasonal business operating about six months per year.
- Spouses, George and Irene, own all of the fixed-value preferred shares that were the result of an estate freeze completed last year.
- A discretionary family trust owns all of the common shares of Opco. Beneficiaries of the trust include George and Irene's children and grandchildren.

Grandchild A is 27-years-old and has recently completed an MBA. He has not worked on the farm in past years; however, he was in need of cash flow so spent four months in the current year, working 40 hours per week.

Grandchild B is 24-years-old and has worked weekends on the farm for the last six years, clocking about 6 hours per weekend for a total of about 150 to 200 hours per season.

Grandchild C is 30-years-old and works in his own professional practice in a city very far away. When grandchild C finished high school at age 17, he worked with George on the farm, full-time for five years before returning to school.

The plan is to pay dividends from Opco to the trust and allocate the dividend amounts as one-third to each of Grandchildren A, B and C.

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For Grandchild A, the dividend amount meets the 'Excluded Business' exception because he worked at least an average of 20 hours per week during the farm's current operating season.

For Grandchild B, the dividend amount does not meet the 'Excluded Business' exception because, while he has worked every year for six years, the work time is less than an average of 20 hours per week during the farm's operating season. As such, the dividend paid to Grandchild B will be taxed at the top marginal rate.

For Grandchild C, the dividend amount meets the 'Excluded Business' exception because he worked at least an average of 20 hours per week during the farm's operating season in at least five prior years.

In summary, Grandchildren A and C will be taxed at their regular marginal rate of tax on the dividends they each receive, while Grandchild B will pay tax at the highest marginal rate on the dividend amount he receives.

In conclusion, the TOSI rules are all encompassing, complex and still evolving as new information continues to be released and interpretations develop. This article is general in nature as it is intended to simply create awareness based on information available at the time of writing. Individuals should reach out to their professional advisors to understand how the TOSI rules will align with their particular set of circumstances.

Below is a list of factors that the CRA has indicated may be considered in their analysis of 'Reasonable Return.' The facts and circumstances specific to each case will be important to the CRA's analysis. It is noted that that list is not exhaustive.

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Figure One

Factor Review

Labour Contribution

- The nature of the tasks performed;
- Hours required to complete the tasks;
- A competitive salary/wage for the tasks in relation to businesses of similar size and industry;
- Education, training and experience;
- Degree and nature of activities in relation to those of a business of a comparable nature and size;
- Time spent on the activity in comparison to time spent in other activities or undertakings;
- Particular knowledge, skills or know-how that the individual possessed;
- Business acumen; and,
- Past performance of functions.

Property Contribution

- The amount of capital contributed to the business;
- The amount of loans to the business;
- The FMV of property (both tangible and intangible property) transferred to the business, including technical knowledge, experience, skill, or know-how;
- Whether the individual has provided property as collateral for loans or other undertakings;
- Whether other sources of capital or loans are readily available;
- Whether comparable property is readily available;
- Whether the property is unique or personal to the individual;
- Opportunity costs; and,
- Past property contributions.

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Risk Incurred

- Whether the individual is exposed to the financial liabilities of the business, whether through guarantees of mortgages, loans or lines of credit or otherwise;
- Whether the individual is exposed to statutory liabilities related to the business;
- Extent of the risk that contributions made by the individual to the business may be lost, whether in whole or part;
- Whether any risk is indemnified or otherwise limited in the circumstances, whether by agreement or otherwise;
- Whether the individual's reputation or personal goodwill is at risk; and
- Past or ongoing risk assumption.

Total Amounts Paid When evaluating this factor, the CRA's documents note that amounts previously paid to the individual should be included in the analysis. Examples offered include payments of any kind including salary or any kind of remuneration, dividends, interest, proceeds or fees, benefits and deemed payments (as may be reasonably required in the circumstances).

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EXAMPLE

Ed owns a private corporation that operates an automotive repair shop. He is in the top marginal tax bracket and wants to reduce the taxes he pays on his income from the shop, which amounts to about $175,000 a year.

Ed's wife is a successful veterinarian earning about the same as Ed, so there is no advantage to splitting income with her. The couples' three daughters, ages 10, 12, and 15, have no earned income and attend expensive private schools.

Ed is considering setting up a discretionary family trust (inter vivos) for the benefit of his daughters and allowing the trust to subscribe to shares of his corporation during a corporate reorganization. Afterwards, he would pay $50,000 of the after-tax corporate income to the trust as a dividend, allocated equally among the girls and used to pay their tuition.

However, tax on split income will apply in these circumstances. Dividends allocated to the daughters are not taxed in the trust nor attributed to Ed. Rather, they are reported as income to each daughter and treated as split income. This means the payment is taxed at 33 percent (2019 amount) federally, plus provincial taxes at their top marginal tax rate. The anti-avoidance rule associated with tax on split income precludes Ed from achieving his desired objective.

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Under the ITA, a parent and minor child involved in this type of income splitting arrangement would be jointly and severally liable for the tax consequences.

EXAMPLE

Barney was the owner of a successful private business, where he and his spouse, Betty, worked full-time since inception. On the advice of his accountants, Barney reorganized the shares of his company by exchanging his common shares for $2,000,000 of fixed-value preferred shares. The ACB of Barney's shares was nominal. Betty subsequently subscribed to new common shares.

Over time, the business doubled in value and Betty and Barney accepted an offer to sell their shares of the business for $4,000,000. The following chart highlights the tax consequences associated with the sale.

	Barney	Betty
Capital gain realized (assuming a nominal ACB)	$2,000,000	$2,000,000
Capital gains exemption	$866,912	$866,912
Estimated income taxes thereon (50%)	$283,272	$283,272
Total taxes paid	$566,544	

In this example, by freezing his position in the business, Barney enabled Betty to subscribe for common shares at nominal cost. When the business was subsequently sold, both Betty and Barney were able to utilize their available capital gains exemption.

It should be noted that tax on split income (TOSI) did not apply in this situation because both spouses were actively engaged in the business and TOSI does not apply to capital gains realized on the disposition of shares of a qualified small business corporation.

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Trusts

Trusts facilitate the ability for a settlor to transfer property, but not control, to the beneficiaries or provide for the devolution of the trust property beyond the current generation of beneficiaries. Trusts are popular tools in Canada's financial landscape for income splitting among wealthy family members, either during the life of the settlor or after his or her death.

Trust Law Basic

In simple terms, a **trust** is a relationship under which one party **(trustee)** holds title to property (trust property) for the benefit of another party **(beneficiary).** The property is contributed into the trust by a person referred to as a **settlor**. The settlor sets out the terms or instructions as to how the trust property is to be managed in a **trust agreement**. While an agreement or document is not necessary in order for a trust to exist, a trust agreement is common.

For a trust to be valid, three certainties must be in place:

- **Certainty of intention** to create a trust. It must be clear that the settlor of the trust intended for a trust to exist.
- **Certainty of subject matter** *(property).* It must be clear which property is being transferred to the trust.
- **Certainty of objects.** It must be clear who the beneficiary(ies) is(are).

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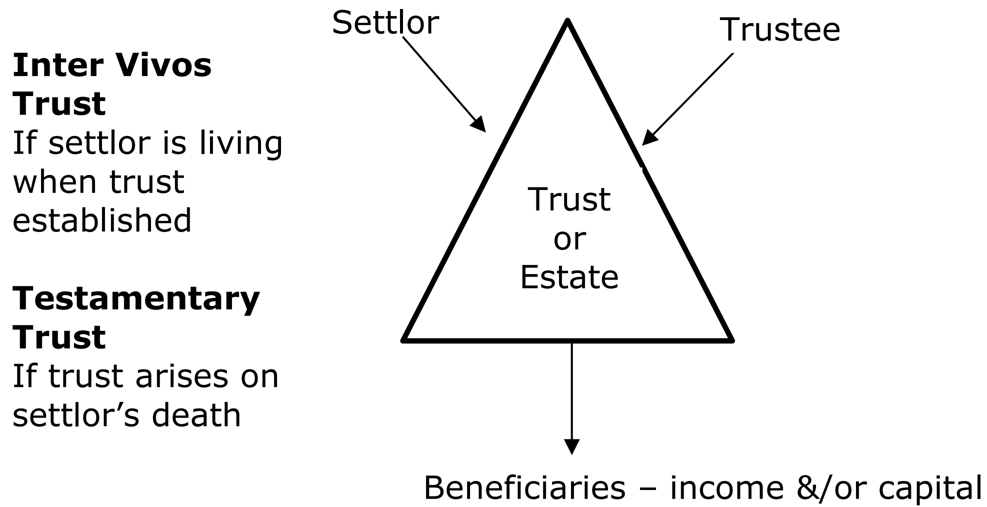
Trust relationships



An estate is considered a trust, and the estate executor[18] or administrator fills the role of the trustee in respect of the estate. Beneficiaries are those who are to benefit from the trust's property and may be income and/or capital beneficiaries depending on the terms set out in the trust agreement.

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[18] The executor may also be referred to as the liquidator or administrator

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Types of Trust

A **testamentary trust** arises as a result of the settlor's death while an **inter vivos** trust is one established while the settlor is living. Typically, a testamentary trust is one arising out of the deceased individual's will or a court order in respect of the deceased's estate under provincial law. From a tax perspective, an inter vivos trust is any trust that does not meet the definition of a testamentary trust. Note that there is no requirement that the settlor, trustee, and beneficiary be different people; however, there are tax consequences that are dependent on how individuals in these roles may be related.

All trusts, inter vivos and testamentary, are taxed at the top marginal tax rate, except for a **graduate rate estate (GRE)** and **qualified disability trust (QDT)** which are taxed at marginal rates. The year-end of a GRE is selected by the executor of the estate and can be any date up to 12 months following the date of the testator's death; otherwise, all trusts are subject to a December 31st year-end.

Trustee's Discretion

The amount of discretion placed in the hands of the trustee with respect to the distribution of trust income and assets is an important feature set out in the trust document. A trust can be **non-discretionary** whereby trust property (income and/or capital) is distributed to the beneficiaries as set out specifically in the trust agreement. Alternatively, a fully **discretionary trust** gives the trustees the power to make decisions as to how much beneficiaries receive. It is also possible for trust agreements to provide some direction with respect to distributions and combine this with some discretionary power to the trustees. Every trust document will set out important details that must be considered by the trustees in their oversight role.

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Trusts are commonly used in financial and estate planning to separate ownership and control of property. You will see trusts used frequently where the settlor wants to retain some degree of control of the trust property and limit the transfer of control to the beneficiary, or provide for the devolution of the trust property beyond the current generation of beneficiaries.

Discussion in this material will focus on personal trusts, which differ from commercial trusts, such as mutual funds, which are used for commercial and business purposes.

Residency

As discussed earlier, **residence** is an important concept in Canadian taxation because liability for income tax is based on status of residence. The residence of a trust was historically based on the place of residence of the trustees, but a 2012 decision by the Supreme Court of Canada in the case of *Fundy Settlement v. Canada*[19] changed the determining factors. The SCC unanimously confirmed a decision of the Tax Court of Canada, stating that the concept of "**central management and control**," a test used for determining the residency of a corporation, applies equally when determining the residence of a trust.

Where trustees are effectively carrying out the factual central management and control of a trust, the place of residence of the trustees continues to be a determining factor for the residence of the trust. Where the central management and control of the trust does not clearly lie in the hands of the trustees as demonstrated by the culmination of all facts and circumstances, residence will be based on the concept of central management and control test similar to a corporation.

Residence of a trust is now based on the jurisdiction in which central management and control resides. As such, careful attention should be given to the location where meaningful decisions are made with respect to the trust.

[19] This case may also be referred to as Garron Family Trust or Michael Trust Corp

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Family Trust

The term **family trust** is a term commonly used to refer to a regular trust established for the benefit of family members and can be either inter vivos or testamentary. The inclusion of the word "family" has no special legal meaning; it is simply a generic term, often used by planners, to refer to a trust set up to benefit the members of a particular family.

Life Interest Trusts

Life Interest trusts include:

1. Spousal (or common-law partner) trust;
2. Alter ego trust;
3. Joint spousal or common-law partner trust.

Each of these three trusts has special income tax rules that provide some type of benefit that is not available to a regular trust.

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Spousal Trust

A **spousal trust** is settled by an individual for the benefit of his or her spouse and must meet the following conditions:

- The beneficiary spouse must receive all income that arises in the trust during his or her lifetime;
- Only the beneficiary spouse may receive or have use of the trust's income or capital prior to his or her death; and,
- Property must vest indefeasibly in the beneficiary spouse or spouse trust within 36 months (an application to the Minister is possible, but is not common).

In addition, if it is a **testamentary spousal trust**:

- The deceased spouse must reside in Canada immediately before death; and,
- The trust must reside in Canada immediately after the time the property vests indefeasibly in the trust.

The term **"vest indefeasibly"** means that the property transferred cannot be revoked, voided, or conditional in nature.

Impact of Will Provisions on the Validity of the Spousal Trust

In some instances, the provisions of a will contravene the requirement that only the spouse or common-law partner can be entitled to income or capital from the trust during that individual's life. Where such a contravention is discovered only after the death of the deceased, it may be remedied by the other beneficiaries' disclaimer or renunciation of any such interest in the trust. Also, a court order providing for relief or support of a dependant may vary the terms of the trust to delete the entitlement of anyone other than the spouse or common-law partner to income or capital during that individual's life.

In addition, a will often provides that debts, expenses, and taxes of the estate as a whole be paid out of the residue of the estate (referred to as an

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exoneration clause). This clause technically constitutes an entitlement on the part of a person other than the spouse or common-law partner to a part of the income and/or capital of the trust during that individual's lifetime. Where the residue is intended to constitute a spousal trust, an exoneration clause technically contravenes the conditions for a spousal or common-law partner trust. However, the ITA permits the personal representative of the deceased to designate certain properties, the value of which must be sufficient to satisfy the payment of such debts and taxes. Such listed properties will (to the extent necessary to pay those debts) be deemed disposed of at FMV.

If this election is made on the deceased's terminal return, the trust will continue to satisfy the conditions required to be an eligible spouse or common-law partner trust.

EXAMPLE

When John died, he left his net estate to a trust for the benefit of his wife. The trust was a spouse trust and qualified for the rollover of capital property from John to the trust at the property's ACB. However, Johns will also provided that his estate would pay his outstanding debts at the time of his death, including income tax liabilities, which totaled $90,000. John's executor designated a $100,000 GIC in the estate to pay those debts, leaving the rest of the property to be rolled to the spouse trust. Because the GIC had no capital gain associated with it, there were no negative tax consequences to the designation.

The ITA provides that a trust is not disqualified as a spousal or common-law partner trust if it satisfies estate, legacy, succession, or inheritance duties payable as a consequence of the death of the taxpayer or a spouse or common-law partner, or when it pays tax on the income of the trust itself. If these are the only amounts to be paid out of the trust, an election is not necessary.

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Tainted Spousal Trust

A **tainted spouse trust** may be created intentionally in a will for tax and estate planning purposes. Such a trust might be created primarily for the benefit of a surviving spouse, but includes terms that prevent the trust from being a qualified spouse trust (which is why the term tainted is used). For example, it might provide for discretionary distributions of income and/or capital of the trust to the deceased's children while the surviving spouse is still alive. Though property passing to such a trust does not qualify for a spousal rollover, it can still be an effective planning strategy.

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EXAMPLE

Millie and Mortie are married and are both 45. It is the second marriage for both of them. Mille has two children, ages eight and 10, from her previous marriage. She has a significant investment portfolio, and she wants to ensure that when she dies, Mortie, who has limited financial resources, has an income for life. Millie also wants to make sure that her children are adequately provided for. In particular, in the event that she dies prematurely, she does not want her children to have to wait until Mortie's death to receive their inheritance (all of these terms are set out in Millie and Mortie's marriage contract).

Millie's major assets are as follows:

- A $500,000 mortgage-free home owned jointly with Mortie
- RRSPs totalling $350,000 (Mortie is beneficiary)
- Stocks and mutual funds with a combined value of $1,000,000 and an ACB of $400,000
- GICs, bonds, and cash totalling $400,000

On Millie's death, the home will pass to Mortie by right of survivorship, and the RRSPs will pass to him as beneficiary. No tax will be payable on these transfers provided the estate executor does not elect out of the rollover treatment.

Millie's will provides for two trusts:

- Trust 1 is a qualifying spouse trust that provides income to Mortie for life.
- Trust 2 is a discretionary trust for the benefit of Mortie and the children. Income can be distributed from the trust to any or all of the beneficiaries (Mortie and the two children) as determined by the trustees. This trust would make a capital distribution to the children at their age 50 thus satisfying Millie's objective of an inheritance to her children prior to Mortie's passing.

On Mortie's death, the assets of both trusts pass to the children if trust 2 has not already made a capital distribution to the children (or to new trusts for the benefit of the children if they are under age 25 at that time).

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In her will, Millie has given her trustees discretion as to the allocation of her investment assets between the two trusts. Subject to Mortie's rights under the marriage contract, the trustees can choose to pass property with accrued capital gains (i.e., selected stocks and mutual funds) to Trust 1, thereby benefitting from the spousal rollover.

Other assets, such as the cash and GICs, can pass to Trust 2. No spousal rollover will be available on the transfer of these latter assets, but this is of no concern given that the assets passing to Trust 2 are not subject to capital gains in any event. It is also possible to transfer stocks and mutual funds with no accrued gains, or with accrued losses, to Trust 2, in which case the lack of a rollover is, again, not relevant.

By using the above strategies, Millie can ensure that both Mortie and her children are adequately provided for, while obtaining complete tax deferral on the disposition of assets at her death.

Income Determined Under Trust Law

In determining whether a spouse or common-law partner is entitled to all of the income of the trust during his or her life, it should be noted that income is determined under trust law and not tax law. For example, under the ITA, half of any capital gain is treated as income, but under trust accounting, all of the capital gains is considered capital (rather than income). Where a trust provides that a spouse or common-law partner is not entitled to any share in the growth in the value of the underlying assets and that the full capital gain will go to the credit of children, the trust may still be a spousal or common-law partner trust. In this situation, the transferee is still entitled to all of the income determined by trust law. However, the will cannot provide that any such capital gain may be paid to a person other than the spouse or common-law partner during that individual's life.

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Spousal Trusts & Life Insurance[20]

A testator will often transfer assets into a trust for his or her surviving spouse after death. The reasons for transferring the assets may be tax-based because a rollover of property is allowed to a spousal trust. Sometimes the testator wants to set aside assets to provide for the ongoing financial security of the surviving spouse. In other cases, the transfer is part of a larger estate plan where the next level of beneficiaries will receive additional assets upon the passing of the life interest spouse.

If one of the assets transferred to a spousal trust is a life insurance policy on the life of the surviving spouse (or a joint last-to-die life insurance policy on the lives of the testator and the surviving spouse), great care must be exercised; otherwise, the spousal trust could be tainted, the tax-free rollover(s) denied, and an income tax liability triggered in the testator's estate. The unexpected result is the premature recognition of the income tax liability embedded in the testator's assets, which would become due at the "wrong time," (i.e. at the death of the first spouse rather than the second).

The crux of the issue is that if a spousal trust owns and funds a life insurance policy on the life of the spouse, the CRA is of the view that there is a possibility of someone other than the surviving spouse benefiting from the assets of the spousal trust. This has led the CRA to give several technical interpretations over the years stating that the spousal trust would be tainted and would therefore be denied the tax-free rollover from the testator.

[20] The following is an excerpt from *Comment, Edition 282, November/December 2013*

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Suggested Strategies

Some of the strategies that have been suggested as a way to avoid the situation of a spousal trust funding a life insurance policy are outlined here.

- Ensure the trust is not "obligated" to fund the life insurance policy. This would involve ensuring no further premiums or deposits are due on the policy and the policy is completely paid-up by the time of the first spouse's death. It is important to note that anyone paying the life insurance premiums on behalf of the trust would be considered to contribute to the trust – which would also taint the trust's ability to qualify as a spousal trust. Great caution needs to be exercised to ensure simple and well-intended actions do not frustrate the intention to maintain spousal trust status.
- If a life insurance policy is found to have been inadvertently transferred into a newly created spousal trust, consideration should be given to immediately transferring title of the life insurance out of the spousal trust to another party before any premiums are paid. Such a transfer would have to take place for consideration equal to the FMV of the policy to ensure the spousal trust is not benefiting another party. The other party could be another trust that is already a tainted spousal trust, which is part of the testator's larger estate plan.
- Consideration could be given to holding the life insurance policies inside a corporation that is owned by the spousal trust. The spousal trust could be the 100 percent shareholder of all shares, or perhaps the 100 percent owner of the fixed-value preferred shares. In this strategy, the corporation would be the beneficiary of the life insurance policy and, if the trust owns all of the common shares, the trust would directly benefit from the payment of the insurance proceeds. Alternatively, if the trust owns only the fixed-value preferred shares, payment of the insurance premiums and receipt of the proceeds would not change the financial position of the trust, which is one of the conditions required to maintain qualifying spousal trust status. However, it should be noted that this strategy was presented to the CRA, who declined to comment on its effectiveness. In this strategy the trust property is not directly used to fund the life insurance policy.

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It should be noted that there may be a risk of a negative assessment by the CRA with any strategy involving life insurance in a spousal trust, so this should be taken into account when devising strategies to meet the qualifying conditions.

Tax planning is a constantly changing arena, and the planner must be aware of the issues, opinions, and alternative strategies. To the extent the testator's estate plan contains life insurance on the life of the surviving spouse (or any other life) and a spousal trust, it takes careful planning to ensure the policies do not end up in the spousal trust. Strategies to reduce the risk inherent with life insurance and a spousal trust include consideration of the use of a second spousal trust that is tainted, or other vehicles to hold the life insurance policies until the eventual benefits are used for the intended estate planning purpose.

Spousal Trust and Death of Life Interest

The spouse or common-law partner who is the beneficiary of a spousal trust is commonly referred to as the "**life interest**." The death of the life interest spouse provides for an immediate year end and deemed disposition of the assets held by the trust, which generally results in a tax liability.

Income earned by the trust up to the date of the life interest's death is deemed to have become payable to the deceased beneficiary and is included on the deceased beneficiary's final tax return.

The income arising from the deemed disposition of the assets held by the trust is included in the trust's income for the year. There is a provision however, that permits the trustee and the administrator of the deceased beneficiary's GRE to jointly elect to have the income taxed in the deceased's final return.

Where the **joint election** is made, the trust and the deceased (along with the deceased's estate administrator) are jointly and severally liable for the income tax liability arising because of the income shift to the deceased's final return. The CRA's published position is that should the deceased's final return be filed without sufficient payment in respect of the tax liability owing, they will immediately initiate a joint liability assessment.

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Alter Ego/Joint Partner

An **alter ego trust** allows a taxpayer aged 65 or older to transfer property on a rollover basis to an inter vivos trust, as long as the taxpayer is the sole beneficiary of the trust (i.e., the only person entitled to receive any capital or income from the trust during his lifetime), and the trust was created after 1999.

A **joint partner trust** allows a taxpayer aged 65 or older to transfer property on a rollover basis to an inter vivos trust, as long as the taxpayer and his or her spouse or common-law partner are the only beneficiaries of the trust during their lifetimes.

Advantages and Disadvantages

The primary advantage of an alter ego or joint partner trust compared to a regular inter vivos trust is that assets can be transferred from an individual into the trust for proceeds equal to the taxpayer's ACB, so can "roll" into the trust with no immediate tax consequences. The individual who transfers assets into the alter ego trust (referred to as the settlor) is also the beneficiary of the trust. Assets held within a trust pass outside the settlor's estate for probate purposes. The trust may also protect the assets from the settlor's creditors.

The downside to these trusts is that the trust property is deemed to be disposed of by the trust at the death of the transferor (in an alter ego trust) or the last death of the transferor and his or her spouse or partner (in a joint partner trust). A regular trust has a deemed disposition every 21 years. In the case of an alter ego or joint partner trust, the deemed disposition arising on the date of death may occur much sooner than a regular trust or could extend beyond the 21 years afforded to a regular trust.

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EXAMPLE

Angus, age 67, is a widower with two adult children. Angus and his children live in British Columbia. His assets include his home, a vacation property in BC, and his non-registered investments, comprised of a portfolio of securities with a $950,000 FMV and an ACB of $600,000.

Angus needs some advice concerning the securities. He wants these assets held in trust over the long term to benefit his grandchildren eventually, but currently needs the income from the securities to support his lavish retirement lifestyle. He cannot afford to gift the securities to his children at this point. Angus is concerned about the $13,300 in probate fees (1.4% is the 2018 amount for BC) that will be payable on the securities on his death.

Angus's advisor suggests an alter ego trust to address his concerns. The $950,000 portfolio could be rolled over to the trust at its ACB of $600,000 without triggering tax on the $350,000 capital gain at the time of the transfer. During his lifetime, Angus would be the beneficiary of all income from the trust, allowing him to maintain his lifestyle. At his death, the trust would be deemed to have disposed of the securities for proceeds equal to their FMV at the time of death, with any resulting capital gain reported to the trust. The capital gain is retained in the trust for tax purposes and is taxed at the top marginal rate.

Because the assets held in the trust would not form part of Angus's estate, they would not be included in his probatable assets and the $13,300 in probate fees would be avoided. After Angus's death, the trust could continue in force, first with his children and then his grandchildren as beneficiaries, which would meet his estate planning objectives.

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Preferred Beneficiary Election

In certain circumstances, an executor or trustee may file a **preferred beneficiary election** with the CRA. The preferred beneficiary election allows income from a trust to be taxed in the hands of a beneficiary while being retained in the trust, and is an exception to the general requirement that trust income must be paid or payable to a beneficiary in the year for it to be taxed in that beneficiary's hands.

Section 108 of the ITA defines a preferred beneficiary as an individual eligible for the disability tax credit, or who is age 18 or older and dependent because of physical or mental infirmity and whose income is less than the total basic personal credit amount.

The advantage of the election is that it permits trust income to accumulate in the trust while being taxed currently at the beneficiary's (presumably) low marginal tax rate and to be distributed as tax- paid capital at some future date. (Accumulated income is described in more detail later).

Preferred Beneficiary

The preferred beneficiary must be the settlor of the trust; a current or former spouse or common-law partner of the settlor; or, the child, grandchild, or great-grandchild of the settlor. In addition, the preferred beneficiary must qualify for the disability tax credit.

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EXAMPLE

Don and Mary have three adult children, one of whom, Susan, is physically challenged. Susan lives at home with Don and Mary, who support her. Don and Mary know they will not always be able to look after Susan. Don has placed $300,000 in a trust for Susan's future welfare. Susan's siblings are also beneficiaries of the trust, which authorizes the trustee to allocate trust income and capital among the beneficiaries on a discretionary basis.

As Susan does not currently need the income, Don has filed a preferred beneficiary election. The $15,000 in annual income that the trust generates will be taxed in Susan's hands and retained in the trust for future use. The outcome is no tax payable because of Susan's personal and disability credits.

When Don and Mary can no longer look after Susan, the accumulated income can be paid out tax-free for Susan's benefit, and the trust can allocate its current taxable income to Susan. Should Susan not need some or all of the accumulated income, the trust can be structured so that some or all of it is distributed tax-free to her siblings, either during Susan's lifetime or at her death.

Once the preferred beneficiary election has been made, the **accumulating income** can be distributed later according to the terms of the trust (the distribution is tax-free), and not necessarily as allocated under the election. The income tax election does not alter the legal rights under the trust.

Taxation of Trusts

A trust (or estate) is generally treated as a separate taxpayer. The rules for the taxation of trusts and their beneficiaries are outlined in Division B, subdivision K (sections 104 to 108) of the ITA. Refer to the Overview of ITA to see how this fits into the overall scheme of the ITA.

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Graduate Rate Estate

A graduate rate estate (GRE) is an estate that arises as a consequence of an individual's death. For deaths that occur after December 31, 2015, to ensure that the estate is treated as a GRE for tax purposes, the estate representative must include the deceased's social insurance number and designate the trust as a GRE when filing the income tax return for the estate's first year-end. GRE status continues for up to 36 months from the individual's date of death, after which the estate remains a testamentary trust but becomes subject to tax at the top marginal rate like all other testamentary trusts.

The rationale behind 36-months is to provide the estate's executor with sufficient time to administer and wrap up the estate.

One GRE

A deceased individual can have only one graduated rate estate and it must be the estate itself that becomes the GRE. This means that testamentary trusts established through an individual's will cannot qualify for graduated tax rate treatment; instead, they are taxed at the top marginal personal tax rate from inception. Examples of testamentary trusts arising upon death through an individual's will include an insurance trust, spousal trust, family trust, and education trust.

Estate planning may involve keeping the estate together and only settling these non-GRE trusts as time passes and nears the 36-month anniversary. However, the estate executor needs to be mindful of obligations to the respective beneficiaries and not unnecessarily delay the establishment of other trusts simply for the tax benefit.

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Estate Created Prior to New GRE Rules

There was no grandfathering for estates and testamentary trusts created prior to January 1, 2016, which enjoyed the benefit of graduated tax rates. The status of pre-2016 testamentary trusts was immediately aligned with the new GRE rules.

- An estate created by a death prior to January 1, 2016, was entitled to access the graduated rate structure for the 36-month period immediately following the date of the individual's death. However, the estate executor was required to designate the estate as a GRE in its first tax filing after January 1, 2016. At the 36-month anniversary following the date of death, the estate no longer qualified for GRE status and was being treated as a testamentary trust under the new tax structure.
- All testamentary trusts created prior to January 1, 2016, other than a trust designated as a GRE, immediately shifted to top marginal tax rates as of January 1, 2016.

Year-End

A GRE has the option to select a non-calendar year-end, which then applies throughout the GRE period.

Other testamentary trusts that do not qualify for GRE status are subject to a calendar year-end (December 31) from the onset.

When a GRE reaches its 36-month anniversary, the point at which its special status ends, it will have a deemed year-end at that date, followed by a subsequent year-end on December 31 in that same year. From there forward, the trust will be subject to a December 31 year-end throughout its remaining existence.

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EXAMPLE

Consider the example of Dara who passed away on February 2, 2019. Dara has a very complicated estate and it will take a considerable period to settle her affairs. Dara's executor, Nuas, will have to be aware of the following dates when managing the estate.

- Nuas can choose the date for the first taxation year of the estate. The first taxation year does not have to be twelve months. Assume that Nuas chooses November 15, 2019, as the first taxation year of the estate, designates the estate as a GRE and files the estate's first tax return.
- Nuas would be required to file the estate's second and third tax returns for the November 15, 2020, and 2021 year-ends, respectively. The second and third tax returns would each be in respect of a twelve-month period.
- Nuas would be required to file a tax return for the period ending February 2, 2022, the 36-month anniversary of Stan's death. This tax return represents the final period during which the estate qualified as a GRE.
- The estate's status shifts to a regular testamentary trust immediately following the 36-month anniversary. As such, the estate is now subject to a calendar year-end, requiring Nuas to file a tax return in respect of the December 31, 2022 year-end, and every December 31 thereafter.

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Allocating Income to A Beneficiary

A trust can allocate income to a beneficiary based on the terms of the trust document. When income is allocated to a beneficiary, it is treated as property income except some types of income retain their character and corresponding special tax preferences. Below is a list of payments that retain their character along with a summary of the corresponding benefit.

- Taxable dividends from a Canadian corporation → recipient beneficiary can utilize the dividend tax credit
- Non-taxable or capital dividends → recipient beneficiary has no income tax consequences associated with the receipt of capital dividends
- Net taxable capital gains → recipient beneficiary can utilize the 50 percent inclusion rate for taxable capital gains and, in some circumstances, the capital gains exemption
- Foreign income and related foreign tax paid by the trust → recipient beneficiary can utilize the foreign tax credit

Deemed Disposition (21-Year Rule)

An individual is generally subject to tax on any gains accrued on property held personally at the time of his or her death unless the property is passed to a spouse or common-law partner. Effectively, gains on property are usually taxed when the property is passed from generation to generation. However, a skilled advisor can set up a trust that will remain in existence for many generations. Since a trust does not "die" as an individual does, the taxation of gains accruing on capital property could be deferred indefinitely.

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To prevent this indefinite deferral, subsections 104(4) and (5) provide for **deemed dispositions (21-year rule)** of the capital property held by a trust. Such dispositions are deemed to occur on the following dates:

- Post-1971 spousal or common-law partner trusts: On the day on which the beneficiary spouse or common-law partner dies, and every 21 years thereafter;
- Pre-1972 spousal trusts: On the later of the day on which the beneficiary spouse or common-law partner dies and January 1, 1993, and every 21 years thereafter;
- Joint spousal or common-law partner trusts: The day on which the survivor dies, and every 21 years thereafter.
- Alter ego trusts: the day on which the settlor dies, and every 21 years thereafter.

However, where a trust that would otherwise be an alter ego trust elects not to be taxed as an alter ego trust, the first deemed disposition date of the trust will generally be the 21st anniversary of the creation of the trust.

- Trusts qualifying under subsections 73(1) or 107.4(3): The day on which the settlor dies, and every 21 years thereafter (i.e. that received a rollover of property because there was no change in beneficial ownership);
- For trusts created prior to January 1, 1972, other than the above: On January 1, 1993, and every 21 years thereafter;
- For trusts created after December 31, 1971, other than the above: Every 21 years after the date of creation of the trust.

On each of these dates, the trust is deemed to dispose of all capital property at FMV and immediately reacquire it at the same value.

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Deemed Disposition - Depreciable Capital Property

Depreciable capital property is also subject to the 21-year deemed disposition rules (it is capital property). As such, it is deemed to be disposed of and reacquired at an amount equal to FMV on the same dates outlined in the section above. Any recaptured CCA and any capital gain are taken into account in the tax calculation of the trust in that year. If the total amount of the deemed proceeds is less than the UCC, however, no terminal loss may be claimed.

Payment of Tax by Installments

To alleviate cash flow problems that might arise on a 21-year deemed disposition, a trust may elect to pay its resulting tax liability in up to 10 equal annual installments, with interest at the rate prescribed at the time of the election. Security will be required for unpaid installments and interest (subsections 159(6.1) and (7)).

Rolling Trust Property to Another Trust

The ITA has special rules that prevent a trust from avoiding the 21-year deemed disposition by simply rolling the trust property to a second trust. In general terms, when property is transferred from one trust to another, the settlement date applicable to the original trust continues to apply for deemed disposition purposes (subsection 104(5.8)).

Exemption from 21-Year Deemed Disposition

Life interest trusts are generally exempt from the 21-year deemed disposition rule. This includes qualifying spousal trusts while the beneficiary/spouse is alive, as well as alter ego and joint spousal/partner trusts.

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Mitigating the Financial Impact of the Deeming Provisions

There are limited options available to avoid or mitigate the financial impact of the deemed disposition rules. However, some strategies are available, as outlined in the following example.

<u>EXAMPLE</u>

Homer died in 1999, leaving his $200,000 estate (mostly term deposits) in trust for the benefit of his two children. The children were minors at the time, and trust income was to be paid to them (or for their benefit) until they each reached age 40, with the capital to be distributed at that time. It is now late 2019 and the beneficiaries are aged 28 and 32.

The trust property has grown to $420,000 in value, still with its original ACB of $200,000. Next year (2020) is the 21st anniversary of the trust and a disposition of all of its capital assets. If the trust retains the property, it will be deemed to have been disposed of the portfolio for $420,000, resulting in $220,000 of capital gains. Regardless of who reports this income (the trust, the children, or a combination) the deemed disposition will result in significant taxes.

Homer included a provision in his will that allows the executor to encroach on some or all of the trust capital for the benefit of the two children, either out of necessity or for tax planning purposes. Accordingly, the executor plans to distribute the estate assets to the children, in-kind, before next year's anniversary. In this way, the trust property can be transferred to the children on a tax-deferred basis, deferring the realization of the capital gain on the property until the children chose to dispose of the property.

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Life Insurance Held by A Trust

A life insurance policy held in a trust is not considered capital property for the purposes of the 21- year deemed disposition rule. This means life insurance can be a helpful tool when planning with trusts. For example, some of the trust assets could be shifted into life insurance, as it is not subject to the 21-year deemed disposition that affects capital property held by the trust. A life insurance policy could be used to replace capital property that has been rolled out to beneficiaries in an effort to avoid triggering a deemed disposition. This can be particularly helpful where a trust involves successive generations of beneficiaries, as the life insurance proceeds would eventually add new capital to the trust when the life insured dies. This replenishes the trust's capital while avoiding tax bills that erode the trust's assets.

EXAMPLE

Anwar's will provides that his estate be held in trust for the lifetimes of his three children (aged 22,28, and 35 at the time of his death) and then be distributed to his grandchildren, in equal shares, at the death of the last of his children. Because the trust was expected to last for several decades, the executors invested fairly heavily in equities to offset the depleting impact of inflation on the trust capital. Twenty years after Anwar's death, in 2014, the trust assets (with an ACB of $300,000) are held in the estate, along with another $200,000 of term deposits, and two of Anwar's children are alive and healthy.

The executor purchases an $800,000 joint-last-to die term-to-100 life insurance policy on the lives of the two surviving children, owned by and payable to the estate. The $800,000 of equities can be rolled tax-free to Anwar's surviving two children to avoid a disposition under the 21-year rule. At the death os the second of these children, the insurance proceeds will be paid to the trust and be distributed to Anwar's grandchildren as per his will.

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Reversionary Trust

Under the **reversionary trust** rules (subsection 75(2)), property income and losses, as well as capital gains or losses from trust property will be deemed to be that of the settlor if a trust holds property on the condition that the property or substituted property:

- May revert to the transferor;
- May pass to persons determined by the transferor at a time subsequent to the creation of the trust; or,
- Transferor's consent or direction is needed to dispose of the property.

This provision applies during the lifetime of the settlor or while he or she is resident in Canada.

While subsection 75(2) can have a nasty outcome, often a bigger concern is that if 75(2) has ever applied to the trust, then subsection 107(4.1) applies. Subsection 107(4.1) prevents the rollout of trust property at cost, except to the settlor or the settlor's spouse.

EXAMPLE

Bo settles a trust with a silver a wafer. The trust is a discretionary trust for the benefit of her two minor children. Bo and her spouse, Hank, are trustees and must unanimously. The trust must distribute the assets in four years when the two children are older than age 18. The trust borrows to buy common shares of Holdco.

Does section 75(2) apply in this situation?

Yes, because Bo (the settlor) controls who receives the silver wafer by the fact the trustees must act unanimously. Since the property (silver wafer) transferred to the trust did not generate any income, there is no income to attribute to Bo. However, subsection 107(4.1) will apply because section 75(2) applied. The result is that the silver wafer and the shares will be deemed to be disposed of at fair market value when distributed out of the trust.

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Testamentary Insurance Trusts

As an alternative to leaving insurance proceeds outright to a beneficiary or to the estate to be placed in a testamentary trust, a testamentary insurance trust can be an effective estate planning tool to reduce probate fees.

EXAMPLE

Andy, a widower, wants to leave his estate to his two children, Jean and Stephanie. His estate consists primarily of his home and a $500,000 life insurance policy. Andy lives in Ontario.

Andy has always been concerned about taxes. Title to the home is registered in both his and Jean's names as joint tenants with the right of survivorship, in order to avoid probate fees at his death. The house is Andy's principal residence, so he is not concerned about capital gains tax. Because the house will to Jean, Andy plans to leave the insurance proceeds to Stephanie, but is concerned about Stephanie spending the capital.

Naming Stephanie beneficiary of the insurance policy avoids probate fees, but exposes the capital to Stephanie's creditors, future spouse, and her general spending habits.

Leaving the insurance policy to Andy's estate to be held in trust for Stephanie seems a better option; however, the $500,000 insurance proceeds will be subject to probate fees of about $7,500.

A compromise solution is for Andy to establish a trust in his will to receive the proceeds of the insurance policy at his death. The trust will be treated as a testamentary trust for income tax purposes when the proceeds are received. Because the assets went into the trust external to Andy's estate (it is not part of his will), no probate fees will apply to proceeds. The approach saves the $7,500 in probate fees. A capital encroachment clause in the trust deed can provide Stephanie with access to the trust capital, if needed.

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Carry-Back of Net Capital Losses from the Estate to the Deceased

An estate may incur substantial net capital losses (realized capital gains less realized capital losses) over time. These losses can generally be carried forward indefinitely to be claimed against capital gains realized in future taxation years, or carried back for up to three taxation years to offset net gains reported in the hands of the estate for any or all of those years.

However, net losses incurred in the estate's first taxation year cannot be carried back because the estate does not have a previous taxation year. Net losses cannot be allocated to the beneficiaries. This can be problematic if the deceased had significant capital gains reported and taxed on his or her final tax return.

This issue is addressed in subsection 164(6) of the ITA, which permits the estate executor to elect to carry back net capital losses, realized during the first year of the GRE, to the deceased's final income tax return. These losses are then treated as though they were incurred in the deceased's final year. This relief is particularly welcomed if the deceased taxpayer was deemed to have disposed of assets at a substantial gain at the time of death, and these assets are subsequently sold by the GRE at a substantial loss.

In order to take advantage of the capital loss carry-back provision, where appropriate, the executor of the GRE must be authorized via the will to file relevant income tax elections on behalf of the deceased and the estate. Further, the loss carry-back provision found in subsection 164(6) of the ITA applies only to net losses incurred in the estate's first taxation year, not necessarily its first calendar year. It is important to consider both the date on which losses are triggered in the hands of the estate and the date for the estate's first fiscal year-end.

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EXAMPLE

Shay, a 63-year-old widow, left her estate equally to her two daughters under her will. At the time of her death, she owned $400,000 worth of common stock with an ABC of $75,000. Under subsection 70(5) of the ITA, Shay has deemed to have disposed of these shares immediately prior to her death for proceeds equal to their fair market value at that time ($400,000), and her estate is deemed to have acquired the shares at an ACB of the same amount.

The results in a capital gain of $325,000, which was reported to Shay's final tax return. Because she has no offsetting capital losses for the year, income of $162,500 was reported on her final tax return resulting in additional tax payable of nearly $75,000.

Shay's shares declined sharply in value just a few days after her death due to a decline in the markets. The decline occurred before her executrix could take control of her assets, and the stock was eventually sold a few weeks later for $100,000, resulting in a loss to the estate of $300,000. Because the estate had no offsetting capital gains in the future, the loss would be of little or no value to the estate.

Shay's executrix filed an election under 164(6) to carry back the $300,000 loss. The loss could then be treated as having been incurred in the year of Shay's death offsetting the $325,000 capital gain realized that the year because of the deemed disposition of Shay's capital assets. The net effect of the carry-back was to reduce the net capital for the gain year of death to $25,000, adding only $5,000 to Shay's tax bill for the year of her death and saving her estate nearly $70,000 in taxes.

Testamentary Trust Planning[21]

Now that testamentary trusts are taxed at the top marginal tax rate, rather than marginal tax rates that were permitted prior to 2016, the tax incentive for using testamentary trusts as part of an individual's estate plan has been eliminated. Yet, while the tax incentive was an enticing factor, there are still valid planning reasons that make testamentary trusts a valuable part of an individual's estate plan.

[21] This segment is an excerpt from *Comment, Edition 279, May/June 2013*

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The deceased individual (testator) could consider using one or more testamentary trusts to accomplish specific objectives when distributing assets of his or her estate to each beneficiary or class of beneficiaries. Below is a collection of strategies that make use of a testamentary trust to accomplish the objectives of the testator.

1. A testamentary trust could protect spendthrift beneficiaries from themselves**.** The trust could be designed to pay out, from the income and capital of the trust at the discretion of the trustee, sufficient funds for the beneficiary to meet reasonable lifestyle needs. This allows the beneficiary to inherit a long-term allowance. Since the beneficiaries do not have unrestricted access to the capital, they are protected from themselves and cannot completely deplete the inheritance.
2. A testamentary trust could hold the beneficiary's inheritance and put in place an appropriate investment manager that would take into consideration the needs of the beneficiary. This strategy allows the testator to provide a beneficiary who is an inexperienced investor with professional investment management rather than leave it up to the beneficiary to invest the capital from the inheritance.
3. A testamentary trust could be designed to motivate certain behaviours from the beneficiaries. For example, the testator may feel that education is very important, so could design a trust to fund the education of the beneficiaries. Another example would be a testator who feels earning an income builds character, who could design a trust that pays a distribution based on the amount of income earned by the beneficiary. The testator should be aware, however, that there are legal barriers that may prevent the testator from controlling certain behaviours through the trust. Some conditions are outside of good public policy (for example, a provision that restricts marriage outside of a faith) and would be voided by the courts. As such, discussion with legal counsel in the establishment of the documentation can provide guidance on unique issues.
4. A testamentary trust could be designed to provide income for a second spouse while ensuring the testator's wealth eventually passes to his or her children.

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Many family situations involve a second marriage and children from the first marriage, leaving the testator with multiple obligations to his or her dependents. A trust could be designed to pay all of the income to the surviving second spouse, along with some access to capital to maintain lifestyle. Any capital remaining upon the second spouse's passing would be distributed to the children of the testator. Certainly, discussions with advisors with respect to family law considerations should be undertaken in light of the family's specific circumstances.

5. A testamentary trust can be designed to stage the inheritance of the beneficiaries. A beneficiary receiving a substantial amount of money all at once could face a steep learning curve with respect to managing money and could make an investment or spending mistakes. Sometimes the beneficiary will not be able to recover from these missteps and the inheritance could be lost. A trust could be designed to pay a beneficiary's inheritance in stages, such as one-quarter at each of ages 25, 29, 33 and 37; this type of staged distribution provides the beneficiary with the opportunity to learn about money management throughout the distribution period, and minimizes the possibility of a major depletion of funds from an error.

Testamentary trusts are an integral element of each of the planning strategies outlined above to meet the testamentary wishes of the deceased and specific needs of the beneficiaries. Because of the breadth of needs and diversity of beneficiaries, testators will often need several testamentary trusts to implement their wishes. In these situations, the multiplication of testamentary trusts is based on needs and is not income-tax motivated.

In simple terms, testamentary trusts have a valid role to play in effective planning in order to accomplish the deceased's testamentary wishes.

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Summary

After completing this module you should have gained a solid understanding of:

- The advantages, disadvantages and practicable methods for income splitting;
- The effect of the income attribution rules on income splitting strategies;
- The value of trusts in pursuing estate plans, both inter vivos and testamentary;
- The importance of trust taxation on the creation and administration of a trust.

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Module 4: Tax Planning for Charitable Giving, Death & Retirement

Learning Objectives

Upon completion of this module, you should be able to:

- Evaluate and synthesize client situations in respect of the tax outcome at death including status quo, probate, alternatives, and reporting;
- Integrate the taxation of registered vehicles at retirement and death to a client's specific circumstances;
- Discuss the taxation and regulation of charities and the impact these have on a charity's operations;
- Explain the tax treatment, benefits, and risks of different types of donations;
- Describe the general approach to the taxation of individuals entering and exiting Canada, including the tax implications related to life insurance policies and the issue of US estate tax.

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Death of a Taxpayer

The death of a taxpayer results in an immediate deemed disposition of most property, creating an immediate tax liability. There are relieving provisions that allow for some tax-deferred rollovers; however, careful attention to the details is important to ensure filing requirements are met and elections are considered on a timely basis. Property and income left upon death may create income tax consequences for the deceased, the estate or beneficiaries of the estate.

Probate

Each province imposes fees (i.e. taxes) to **probate** the will of a deceased individual. To probate an estate means to obtain the Court-issued document confirming the legal validity of the deceased's will and the name of the person (people) who is (are) authorized to deal with the deceased's estate **(Estate Executor/Administrator/Representative)**.

Generally, the personal representative completes an inventory of the deceased's estate at death (with a deduction allowed in some provinces for certain debts of the estate) and probate fees are based on the value of the estate. Life insurance proceeds passed to a beneficiary named under the policy are not considered part of the estate. RRSP and RRIF assets with a named beneficiary are treated similarly and pass outside of the estate.

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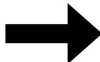
Preparing the Estate

Is there a will?

	Yes	No
Authorized Person 	Executor or Estate Trustee named in Will	Administrator(s) appointed by the courts or Estate Trustee

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Probate Fees by Province/Territory

The following table summarizes the probate fees/taxes imposed by each province and territory on the value of a deceased's estate:

Probate Fees by Province/Territory (as of 2018)	
Alberta	• $35, where estate's net value does not exceed $10,000 • $135, where estate's net value exceeds $10,000 but not $25,000 • $275, where estate's net value exceeds $25,000 but not $125,000 • $400, where estate's net value exceeds $125,000 but not $250,000 • $525, where estate's net value exceeds $250,000
British Columbia	• $6 for every $1,000 or portion thereof by which estate's value exceeds $25,000 but not $50,000 • $150 + $14 for every $1,000 or portion thereof by which estate's value exceeds $50,000
Manitoba	• $70, where estate's value does not exceed $10,000 • $70 + $7 for every additional $1,000 or portion thereof by which value exceeds $10,000
New Brunswick	• $25, where estate's value does not exceed $5,000 • $50, where estate's value exceeds $5,000 but not $10,000 • $75, where estate's value exceeds $10,000 but not $15,000 • $100, where estate's value exceeds $15,000 but not $20,000 • $5 per $1,000 or portion thereof, where value exceeds $20,000
Newfoundland and Labrador	• $60, where estate's value does not exceed $1,000 • $60 + $0.60 for every additional $100 of estate's value over $1,000

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Northwest Territories	• $25, where estate’s value does not exceed $10,000 • $100, where estate’s value exceeds $10,000 but not $25,000 • $200, where estate’s value exceeds $25,000 but not $125,000 • $300, where estate’s value exceeds $125,000 but not $250,000 • $400, where estate’s value of $250,001 or more
Nova Scotia	• $85.60, where estate’s assets do not exceed $10,000 • $215.20, where estate’s assets exceed $10,000 but not $25,000 • $358.15, where estate’s assets exceed $25,000 but not $50,000 • $1,002.65, where estate’s assets exceed $50,000 but not $100,000 • $1,002,65 + $16.95 for every $1,000 or portion thereof by which estate’s assets exceed $100,000
Nunavut	• $25, where estate’s value does not exceed $10,000 • $100, where estate’s value exceeds $10,000 but not $25,000 • $200, where estate’s value exceeds $25,000 but not $125,000 • $300, where estate’s value exceeds $125,000 but not $250,000 • $400, where estate’s value exceeds $250,000

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Ontario	• $5 per $1,000 or portion thereof by which estate's value exceeds $1,000 but does not exceed $50,000 • $250 + $15 per $1,000 or portion thereof by which estate's value exceeds $50,000
Prince Edward Island	• $50, where estate's value does not exceed $10,000 • $100, where estate's value exceeds $10,000 but not $25,000 • $200, where estate's value exceeds $25,000 but not $50,000 • $400, where estate's value exceeds $50,000 but not $100,000 • $400 + $4 per $1,000 or portion thereof by which estate's value exceeds $100,000
Quebec	• No probate fee or tax • Quebec charges a flat fee where a natural or legal person files a request for a will verification with the Superior Court.
Saskatchewan	• $7 per $1,000 of the estate's value or portion thereof
Yukon	• Nil, where estate value is $25,000 or less • $140, where estate's value exceeds $25,000

Probate Planning

The concept of **probate** planning involves looking at options to avoid delays and public disclosure together with minimizing the cost (depending on the province) associated with probating a will. However, with every strategy there is the necessity to thoroughly understand the costs and risks. Any probate planning analysis should include evaluating the costs and risks compared to the benefits of the strategy.

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Jointly Owned Property

Property registered in **joint title with rights of survivorship** will pass to the survivor upon the death of one of the joint owners. The transfer of title is by operation of law and will occur automatically without the need for a will.

Some individuals place property into joint title with their children in order to avoid probate fees and pass the property on to their children.

When transferring the title of property into joint ownership, the timing of the disposition for tax purposes will be an issue and will be dependent on the objectives of the first owner.

If the intent is to avoid probate and not transfer an interest in the underlying property, then the disposition of the property will occur upon death. However, if the objective is to share ownership of the property immediately upon transfer, then the first owner will be deemed to have disposed of half of the property immediately and the other half upon death. Care and professional advice is important on these types of transfers.

A second issue to consider is the equalization of inheritances. If a child receives property through the right of survivorship, the property is received outside of the estate. If that same child is named as an equal beneficiary in the will, then it may be that the child receives a greater share of the overall estate than the deceased actually intended. Careful planning is required to ensure that beneficiaries receive what was intended, and no one beneficiary becomes entitled to more than another unless this is the original intention. Integrating named beneficiary designations together with other estate strategies, including beneficiary designations in a will, will help ensure distributions fulfill the deceased's testamentary objectives.

Other considerations when shifting the title of property include family law concerns and creditor protection. Both of these issues need to be carefully considered to ensure that unexpected consequences because of family law or creditor issues do not arise in respect of the person with whom property is being shared. It is essential to seek professional advice on any such transfer.

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Inter Vivos Trust

An individual may opt to use an **inter vivos trust** as a means by which to avoid probate on death. By transferring assets to an inter vivos trust during the settlor's lifetime, it removes the assets from the direct ownership of the individual, and the trust assets do not flow through the settlor's estate. Instead, the settlor's wishes are reflected in the trust document (e.g. how and when income from the assets and the assets themselves are to be distributed). This means assets held in a trust do not attract probate fees.

The significant issue is that the client has to implement a trust early and needs to ensure that the trust is validly constituted and administered.

A second issue is the potential for a deemed disposition by the settlor when property is transferred into the trust, depending on the nature of the trust. For example, the transfer of property to a regular inter vivos trust would cause a deemed disposition at the time of transfer. However, use of an alter ego or joint partner trust would allow for a tax-deferred rollover.

A third issue to consider is that the trust is deemed to have disposed of its capital assets every 21 years. This could mean a tax liability is realized before the settlor's death. This issue can be eliminated if the trust qualifies as an alter ego or joint partner trust. For an alter ego trust, the first deemed disposition occurs on the death of the life interest beneficiary. For a joint partner trust, the first deemed disposition occurs on the last death of the two life interest beneficiaries.

General Taxation

Deemed Disposition

Every individual is deemed to have disposed of most types of property owned at the moment before death for proceeds equal to fair market value (FMV). FMV would be determined by taking into account all relevant facts at the time of death, with the exception of the impending death.

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Such property could be owned 100 percent by the deceased or the property could be held in joint title with another person. Property registered in joint title with rights of survivorship will pass automatically to the survivor, but the deceased will still be deemed to have disposed of his or her interest in the property. The value of the deceased's interest is based on the facts of the situation. In evaluating the situation, the CRA will consider evidence that includes the amount of financial contribution towards the purchase, length of holding period, and recent title changes.

Property held in joint title as tenants-in-common passes through the estate, and the deceased is deemed to have disposed of his or her interest.

The statutory authority for the deemed disposition is found in many sections of the ITA and each reference is to a specific type of property:

- Capital property: Subsection 70(5);
- RRSP: Subsection 147(8.8);
- RRIF: Subsection 146.3(6).

Capital Property

As previously noted, individuals are deemed to have disposed of all of their capital property at the moment before death for proceeds equal to FMV. **Capital property** is generally defined as property that can produce income much like a tree that can produce fruit.

The deemed disposition of capital property will trigger the realization of any accrued capital gains and possibly the recapture of CCA.

EXAMPLE

Clyde, a widower, owns a small apartment building and is wondering what his tax exposure would be upon his death.

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(EXAMPLE CONT'D)

		Land	Building	Total
Fair market value	A	$1,000,000	$1,000,000	$2,000,000
Cost base	B	$600,000	$400,000	
Underpreciated capital cost	C	N/A	$300,000	
Capital gain	A-B	$400,000	$600,000	
Taxable capital gain		$200,000	$300,000	
Recaptured capital cost allowance	B-C	N/A	$100,000	
Income inclusion		$200,000	$400,000	$600,000

Spousal Rollover

An exception to the deemed disposition upon death rule occurs when property passing to a surviving spouse, common-law partner or a spousal trust. In such a situation, the deceased's ACB becomes the ACB for the surviving spouse or common-law partner.

As per subsection 70(6), to be eligible for the spousal rollover, both of the following criteria must be met:

- The spouse must be resident in Canada;
- The property must vest in the spouse indefeasibly within 36 months of death.

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The subsection 70(6) rollover is available to a spousal trust if all of the following criteria are met:

- The trust is resident in Canada;
- The property vests in the trust indefeasibly within 36 months of death;
- The spouse (life interest) is entitled to all of the income earned in the trust during his or her lifetime;
- No one other than the spouse is entitled to the capital of the trust before the death of the beneficiary (life interest) spouse.

Vesting Indefeasibly

Vesting indefeasibly means that the surviving spouse must have full legal control over the property. This means, for example, the spouse has full legal control to sell the property. An example of not having control arises when another party has a contractual right to buy the property from the estate, such as in a buy-sell arrangement.

EXAMPLE

Victor passed away and set up two trusts in his will.

1. He bequests $1,000,000 of cash to Trust 1 to pay all of the income to his spouse, Victoria, and pay the capital to his children upon Victoria's passing.

2. He bequests his $5,000,000 to stock portfolio to Trust 2with the provision to pay the income to Victoria, the $250,000 of capital to each child upon reaching the age of 30, and the capital remaining upon Victoria's passing to the children.

3. He bequests his $2,000,000 rental apartment building to Trust 3 with the provision to pay all of the income to Victoria and transfer title to the children upon Victoria's passing. However, Victor inserted a provision that Victoria's income is to be cut in half if she remarries.

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4. He bequests $2,000,000 of common shares of private business to Trust 4 with the provision to pay all t eh income to Victoria and transfer title to the children upon Victoria's passing. These shares are subject to a buy-sell arrangement with Victor's partner Jack, and will be exchanged for cash 12 months after death as per their shareholders' agreement.

- Trust 1 is a qualifying spousal trust;
- Trust 2 is not a qualifying spousal trust because someone other than the spouse had access to capital during the spouse's lifetime;
- Trust 3 is not a qualifying spousal trust because the spouse was not entitled to receive all the income;
- Trust 4 is not a qualifying spousal trust because the property did not vest indefeasibly in the trust.

Automatic Rollover

The rollover to a surviving spouse is automatic for income tax purposes, which means any bequest will be treated on a rollover basis. The executor may elect out of the **automatic rollover** by utilizing subsection 70(6.2). If the executor elects out of the spousal rollover provision, the property will be deemed disposed of at FMV, and the estate will be liable for any income tax liability arising.

Paying the Tax

The deemed disposition rule can create a significant income tax liability, which may create cash flow difficulties for the estate.

To relieve some of the pressure of paying the income tax liability by the due date, the possibility of making instalments may be an option. The income tax liability in respect of rights or things and the deemed disposition rules of capital property arising on the terminal tax return can be paid in a maximum of 10 annual instalments.

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Interest at the prescribed rate plus four percent would be due along with sufficient security. The amount that qualifies for deferred payment is calculated by determining the deceased's income tax liability with and without the income inclusion of the deemed disposition rules.

Alternative Minimum Tax

The **alternative minimum tax** does not apply in the year of death. Where the deceased paid alternative minimum tax in prior years, a minimum tax carryover may be available to reduce taxes payable in respect of the year of death. The executor must complete CRA Form T691, Alternative Minimum Tax, and file it with the ordinary return for the year of death. The carryover cannot be applied to reduce taxes payable under the optional tax returns.

Types of Returns

On death, one or more income tax returns must be filed.

- The tax return for the year prior to death, if not filed before the testator's death;
- The final tax return (or terminal return) for the year of death;
- Tax return for rights or things up to the date of death (optional);
- Tax return for income from a sole proprietorship or partnership for the period after the date of death to the year-end of the sole proprietorship or partnership (i.e. this is only applicable if the year-end of the business is after the date of death). Income up to the date of death would be reported on the deceased's terminal tax return.

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Final Return

An individual's **final T1 income tax return** covers the period from January 1 of the year of death to the date of death and must be filed within six months of the date of death or by the filing due date for that year, whichever is later. The normal filing due date for individuals is April 30 of the following year, or June 15 of the following year if the individual or her cohabiting spouse or common-law partner was a sole proprietor or partner in a business.

The **spouse's or common-law partner's return** is generally due at the same time as the deceased's terminal return.

Filing Deadline for Year Prior to Death

Where the deceased dies between January 1 and the normal filing deadline (i.e. April 30 or June 15) without having filed a return for the previous year, the deadline for filing the T1 return for that previous year for the deceased and for the surviving spouse or common-law partner is extended to six months after the date of death.

If the deceased dies after the normal filing deadline (i.e. April 30 or June 15) without having filed a return for the previous year, there is no extension of the filing deadline for that year.

Filing Deadlines for Final Return Deceased (or spouse or common-law partner) was NOT a business owner		
Death occurred in the following period:	**Current year return due**	**Prior year return due**
January 1 to April 30	April 30, following year	Six months after death
May 1 to October 30	April 30, following year	Late – no extension
November 1 to December 31	Six months after death	Late – no extension

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Filing Deadlines for Final Return Deceased (or spouse or common-law partner) was a business owner		
Death occurred in the following period:	**Current year return due**	**Prior year return due**
January 1 to June 15	June 15, following year	Six months after death
June 16 to December 15	June 15, following year	Late – no extension
December 16 to December 31	Six months after death	Late – no extension

EXAMPLE

A business owner dies on March 31, 2019, having not yet filed an income tax return for 2018. Both the deceased's and the surviving spouse's 2018 returns are not due until September 30, 2019 (six months after the date of death) and their 2019 returns are due by June 15, 2020.

Payment of Taxes

Income taxes payable on death are due on the later of April 30 in the year following death and six months after the date of death, regardless of when the returns calculating those taxes are due. This means payment is due on April 30 of the following year when death occurs between January 1 and October 31.

When death occurs between November 1 and December 31, payment is due six months after the date of death. The CRA charges interest on the unpaid amount from the due date to the date of payment.

Rights or Things Return

The income of a taxpayer for the year of death must also include the value of **rights or things**. In simple term, this refers to amounts that have been earned and are receivable but have not yet been received.

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Examples of items that are classified as rights or things include:

- Dividends declared but unpaid at death;
- Bond coupons matured but uncashed at death;
- Annuity contracts purchased through rollovers of RRSP refunds of premiums or certain provincial pension plan transfers;
- Cash basis accounts receivable and inventory (e.g. farm inventory);
- Certain employment-related income owing at the date of death (e.g. salary, wages, commissions, EI benefits, CPP/QPP benefits and vacation pay not taken) but pertaining to a pay period completed prior to death (amounts accrued between the end of the last pay period and the date of death are not rights or things but regular income);
- A deceased partner's share of the income of a partnership from the end of the last fiscal period to the date of death, if the partnership is not automatically dissolved on the death of one of its partners. It should be noted that the last item, a deceased partner's share of profit from the date of death to the year-end of the partnership can be declared as a right or thing and included on that tax return or filed on a separate tax return.

EXAMPLE

Rita's next pay date is June 20, for the period June 1 to 15. She had a stroke on June 13 and died on June 19. At the time of her death, Rita had not been paid her employment income earned for the period June 1 to June 15. This salary owing to Rita is considered a right or thing and could be claimed on a separate rights or things return.

Exclusions

Rights or things do not include capital property, eligible capital property, land inventory, resource properties, or interests in life insurance. A deceased taxpayer is not considered to have a right or thing in respect of an RRSP, RRIF, or (usually) RPP.

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Rights or Things Planning

It is possible to elect to file a separate optional tax return for rights or things that would otherwise be included in the deceased's income in the terminal return. This optional tax return permits the basic (personal, age, spouse, or common-law partner) and other tax credits to be claimed again without affecting entitlement to those same credits under the terminal return. The filing of a rights or things return also permits a portion of income, which would otherwise be taxed at the deceased's highest marginal rate, to be taxed at a lower (or possibly nil) marginal rate.

EXAMPLE

At the time of his death, Shaun held rights or things worth $6,000 and the income on his terminal return (excluding the rights or things) was over $100,000. If the rights or things are included in his terminal return, they will be subject to tax at a high marginal rate (i.e., 45 percent), resulting in about $2,700 of taxes payable on the $6,000 of additional income. By reporting the $6,000 on a separate optional rights or things return, the $6,000 of income will be fully offset by the available basic personal tax credit, resulting in no tax payable on the $6,000 of income.

The election to file a rights or things return must be made by the later of 12 months from the date of death and 90 days after the mailing of any notice of assessment for the year of death.

Transfers to Beneficiaries

Where a right or thing is distributed or transferred to beneficiaries, it is not taxed to the deceased but to the beneficiary at her own marginal rates when the right or thing is actually realized.

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EXAMPLE

At the time of her death, Dorothy held two major rights or things valued at $16,000 and $10,000 respectively. The beneficiary of her estate is her adult daughter Ralela.

If Ralela opts to use a rights or things return, then all rights or things must be included on that return. There is an exception if a right or thing is transferred to the beneficiary. In this case, because the combined rights or things exceed the available tax credits, some income tax will be payable. However, because Ralela is the beneficiary of both of these assets and she has no other income, tax savings could be achieved by transferring one of the rights or things directly to her and filing a rights or things return for the other. While Ralela will have to file an income tax return claiming the income from the right or thing transferred to her, there is an overall tax savings.

Alternatives for Filing

The personal representative has three alternatives regarding a deceased's rights or things:

1. Elect to file a separate optional tax return for rights or things;
2. Transfer rights or things to a beneficiary and remove their value from the income of the deceased; and,
3. Include the rights or things in the deceased's terminal return.

If either of the first two alternatives is not selected within the time prescribed, the third alternative automatically applies. Where only some of the deceased's rights or things are transferred to beneficiaries, the other two alternatives remain available with respect to the rights or things remaining in the estate. The CRA takes the position that an optional return must include all rights or things other than those transferred to beneficiaries within the time prescribed. This means it is not possible to file an optional return for some rights or things and include others in the terminal return.

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Filing Dates

Where the deceased was entitled to rights or things, the personal representative may file a separate T1 return in respect of the value of those rights or things as of the date of death. This return must be filed by the later of one year after death or 90 days after the mailing of any notice of assessment or reassessment for the final return for the year of death.

Reporting of Capital Gains & Losses

A taxpayer may have many actual **dispositions** or **deemed dispositions** in the year of death. The combined result of these dispositions is a net taxable capital gain or loss.

A **net taxable capital gain** is taxed in the year of death.

A **net capital loss** can be applied against the taxable capital gains of the three immediately preceding years. Any remaining net capital loss in excess of any capital gains deduction claimed can then be applied to reduce other income in the year of death and/or the immediately preceding year.

Net allowable capital losses carried forward from prior years can be applied against net taxable capital gains in the year of death.

EXAMPLE

At the time of his death, Moe had $47,000 in unused allowable capital losses carried forward from the previous two taxation years. He had not used any of his lifetime capital gains exemption.

A deemed disposition of capital property not qualifying for the capital gains exemption resulted in the realization of $22,000 of taxable capital gains for Moe's terminal tax year.

The executor could claim $22,000 of the carried-forward allowable capital losses against the $22,000 of taxable capital gains in Moe's terminal income tax return. The balance of $25,000 of carried-forward allowable losses could be used as a deduction against other income reported on Moe's final tax return.

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Any remaining losses cannot be carried over to the estate or to beneficiaries. For these reasons, it is sometimes useful to trigger a FMV disposition on death rather than using tax-free rollovers for capital property. The inclusion of a **capital gain** or **recapture of CCA** can absorb losses that might otherwise be lost.

RRSP & RRIF Named Beneficiary[22]

Beneficiary Beware

Every taxpayer is responsible for paying his own income tax liability when it is due. To the surprise of many, there are situations when the CRA has the right to utilize an alternative remedy if individuals or their representatives fail to comply. Even more shocking for some is that individuals named as beneficiaries under an RRSP or RRIF can unwittingly become indebted to the CRA.

Death of an RRSP & RRIF Annuitant

The death of an **RRSP** or **RRIF annuitant** creates an income inclusion for the deceased equal to the FMV of the property held within the RRIF or RRSP. This income amount is included in the annuitant's income for the year of death, adding to other tax liabilities that may arise in the final tax return.

There are some rollover situations that create exceptions to the general rule. For example, when the deceased's spouse or financially dependent children or grandchildren are named as beneficiaries, the flow of the funds can create an offsetting deduction for the deceased and eliminate the tax liability that would otherwise arise from the deemed disposition at death of the RRSP or RRIF.

[22] This section is an excerpt from *Comment, Edition 287, Sept/Oct 2014*

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Through these rollover exceptions, an amount equal to the RRSP **"refund of premiums"** or RRIF **"designated benefit"** (which is essentially the value of the plan at the date of the annuitant's death) offsets the deceased's income inclusion. Funds are then taxed in the hands of beneficiaries when withdrawn from the plan.

Joint & Several Liability

When a beneficiary receives RRSP or RRIF funds directly under the terms of the plan, and no rollover applies, that beneficiary becomes **jointly and severally liable** together with the deceased for the amount of taxes owing in respect of the proceeds received. If an estate receives the proceeds directly as the beneficiary of the plan, it is the estate that is liable for the taxes owing. A beneficiary of the estate who subsequently receives funds from the estate is not jointly liable.

The Estate's Responsibility

The estate is normally responsible for paying the deceased's tax liability including that which arises from the deemed disposition of any RRSP and RRIF assets. When there is a deficiency of funds available within the estate, a beneficiary's joint and several liability extends the CRA's reach, providing a remedy for recovering amounts owing. The CRA cannot demand all of the RRIF or RRSP proceeds, but rather the remedy is limited to the collection of taxes owed in respect of the RRIF and RRSP proceeds.

In a June 2013 decision by the Tax Court of Canada, Justice Rowe reinforced a prior court's decision with respect to how the amount owing by a beneficiary under a joint and severable liability is to be calculated. The ruling sets out the degree of exposure that arises when an estate lacks sufficient resources to fund the tax liability specifically related to the RRIF or RRSP.

In *Higgins v. the Queen*, the facts are as follows:

- Arthur Higgins passed away on February 12, 2002;
- He had a non-registered segregated fund policy valued at $10,192, with his two daughters named as beneficiaries;

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- He had an RRIF of $29,272, also with his two daughters named as beneficiaries; they were not financially dependent on him;
- He had a small bank account that was used to pay for funeral expenses;
- By the time the case was heard by the court, the estate owed taxes, interest, and penalties totaling approximately $18,000.

The CRA assessed each of the sisters for $5,096 in respect of the property received as beneficiaries under their father's segregated fund policy, and $6,047 each in respect to the sisters' joint and several liability for tax in respect of their father's RRIF.

In determining a beneficiary's exposure to the annuitant's income tax liability in respect of an RRSP or RRIF, Justice Rowe reconfirmed a prior court's approach that utilized a two-step calculation. The first is to calculate the deceased's tax liability on his final tax return without the RRSP or RRIF proceeds reflected in the income calculation.

Then, the tax liability is recalculated with the inclusion of the RRSP or RRIF proceeds. The difference between the income tax liabilities arising under each scenario becomes the beneficiary's exposure under the joint and several liability provision for income taxes. In this case, the CRA was ordered to re-assess the two daughters' shared liability.

There remained the issue of the daughters' liability pursuant to their status as beneficiaries of the segregated fund. The judge undertook an extensive review of the word "transfer" and implications in respect of beneficiary designations under insurance policies. The bottom line of the judge's review is that the CRA could not assess the daughters for their father's income tax liability in respect of the funds they received as designated beneficiaries under the segregated fund policy. The funds received were considered life insurance proceeds payable to a named beneficiary and did not form part of the father's estate.

Very few people like to pay taxes and even fewer people want to pay someone else's. Beneficiaries should be aware of the CRA's ability to collect taxes, particularly when the funds flow directly through a RRIF or RRSP beneficiary designation.

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Farm & Fisher Property

The ITA provides a special rollover for farm and fishing property that moves from one generation to the next. The provision is designed to defer that accrued income tax liability on farming and fishing property as long as the business stays in the family. The accrued tax liability would only become due if the farming and fishing property is sold for proceeds greater than the owner's cost base.

Application of the Provision

The farm and fishing rollover provision can be used while alive or by the executor upon death.

The parent can elect any proceeds of disposition between his or her cost base and the FMV of the property. By electing at an amount higher than the parent's cost base, the parent can trigger a capital gain that could be offset by the parent's capital gains exemption. It should be noted that if the parent sells the farming/fishing property to the child, the parent's proceeds of disposition is the greater of the actual selling price and the elected amount.

The child is deemed to have paid an amount equal to the parent's elected amount and this becomes the child's cost base. If the child's payment is greater than the parent's elected amount, this higher amount becomes the child's cost base and parent's proceeds of disposition.

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Criteria for Rollover Treatment

In order to qualify for this rollover treatment, the following criteria must all be met:

- Canadian land or depreciable property that prior to death was used principally in a farming business in which the deceased, the deceased's spouse or common-law partner, or any of the deceased's children was actively engaged on a regular and continuous basis;
- An interest in a family farm partnership;
- A share of the capital stock of a family farm corporation, including a family farm holding corporation;
- Property used in the business of farming that was leased by the taxpayer to a family farm partnership or family farm corporation owned by the taxpayer, or the taxpayer's spouse or common-law partner, or children.

Family Farm Corporation

A **family farm corporation** is one where all or substantially all, of the FMV of the corporation's assets are used principally in carrying on a farming business primarily in Canada, in which the deceased, or a spouse, common-law partner, child, or parent of the deceased, was actively engaged on a regular and continuous basis. A corporation may also hold shares or debt of a corporation that would itself qualify as a family farm corporation.

Farm Rollover

The **farm rollover** is available where the property passes initially to a trust for the exclusive use of a spouse or common-law partner before passing on to a child who is a Canadian resident. However, in that instance, the question of whether the property is used in the business of farming must be determined at the date of death of the surviving spouse or common-law partner. In addition, there is no requirement that the farming activities be carried on by family members at that time. Under certain circumstances, the rollover also applies to replacement property acquired by the spouse trust.

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Testamentary Trust

The property may be held in a testamentary trust if, by the terms of the trust, it vests indefeasibly in the child, although it is not transferred to the child until the child attains a certain age. The farm rollover applies even if the deceased was not a Canadian resident, but the child must be resident in Canada immediately before the taxpayer's death. There is no requirement that the property be used in a farming business after the death of the deceased.

Automatic Rollover

The rollover is automatic and the ACB or the capital cost and the UCC of the property are carried over to the child. However, the personal representative may elect to make the transfer at any amount between the property's cost amount and its FMV.

EXAMPLE

Jackson died owning qualified farm property with an FMV of $2,000,000 and an ACB of $600,000. In his will, he left the farm property to his two sons (both Canadian residents) in equal shares. At the time of his death, Jackson had not used any of his $1,000,000 capital gains exemption.

Jackson's executor elected that proceeds of disposition for the farm property be $1,600,000. This allowed for the realization of $1,000,000 of capital gains in Jackson's terminal T1 income tax return, which could then be exempt from tax using the capital gains exemption.

Jackson's sons received the property with an ACB equal to Jackson's deemed proceeds of disposition of $1,600,000 ($800,000 for each son's interest).

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Clearance Certificate

Before distributing any of the property of the trust or estate, a clearance certificate should be obtained; this certifies that all taxes, CPP contributions, EI premiums, interest, and penalties have been paid or satisfactorily secured. The CRA will not issue a certificate until all required income tax returns have been filed and assessed, and all taxes, contributions, interest, and penalties have been paid or secured.

Receipt of the certificate provides the estate representative with the assurance that no further taxes are owed and removes the representative from personal liability. If the estate representative distributes estate property without first obtaining the certificate, it can create a personal liability for the representative with respect to unpaid taxes, interest, and penalties to the extent of the property distributed.

An application for a clearance certificate is made by submitting a completed Form TX19 – Asking for a Clearance Certificate.

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Charities

This section examines the different types of charitable organizations operating in Canada, requirements for becoming a registered charity, and the tax treatment of charitable organizations and their donors. On completing this module, advisors will better understand the tax and other regulations that govern charities and the impact these have on a charity's operations.

Tax Rules Governing Charities

Canadians contribute to charitable organizations in a wide variety of ways, one of which is monetary donations where official receipts are issued so the taxpayer may claim tax credits available through the income tax system. Canadians donated nearly $9 billion dollars based on 2016 tax filings.

Out of 26.3 million taxpayers, approximately 5.4 million claimed a donation tax credit. The median donation was $300, where half of all taxpayers donated less than $300 and the other half donated more than $300.

The average amount claimed as a donation tax credit shows an upward trajectory as the age of the taxpayer increases. For example, taxpayers aged 24 and under donated an average of $420, whereas the average donation amount nearly doubles to $830 for taxpayers aged 25 to 34. This upward trend continues as the age bands increase – ages 35 to 44 averaged $1,220, ages 45 to 54 averaged $1,560, ages 55 to 64 averaged $1,800 and ages 65 and over capped off at $2,250.

In part, the significant number of contributions being made to registered (as opposed to unregistered) charities can be attributed to the official receipts registered charities provide, which result in a tax credit to the donor.

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Classification of Charities & Non-Profits

Both non-profit organizations and charitable organizations typically provide services without any expectation of profit for the work done.

A **Non-Profit Organization (NPO)**, as defined under paragraph 149(1)(l) of the ITA, is a club, society, or association operated solely for social welfare, civic improvement, pleasure, or recreation, but not for profit (note that an NPO is not considered a charity). No portion of the income of an NPO can be payable to or available for the benefit of a proprietor, member, or shareholder of the association. If an NPO meets all of these criteria, it is exempt from tax under the ITA.

Although charities and NPOs share similar characteristics, charities are established exclusively for charitable purposes, and can be structured either as organizations, public foundations, or private foundations.

A **charitable organization** carries on its own charitable activities and has an arm's-length board of directors. A charitable organization typically receives its funding from a variety of arm's-length sources (e.g. public donations from corporations and individuals).

Rather than exclusively carrying out charitable activities in its own right, a **public charitable foundation** usually gives more than 50 percent of its income annually to other qualified charitable **donees**. A public foundation may be structured as a corporation or a trust and its directors/trustees deal with each other on an arm's-length basis.

A **private charitable foundation** can either carry out its own charitable activities or give funds to other qualified donees, usually other registered charities. A private foundation may also be structured either as a corporation or a trust and the majority of its directors/trustees do not deal with each other at arm's length. Further, most funding for a private foundation typically comes from one person or a group of people (i.e. a family) who do not deal with each other at arm's length. An example of a large and internationally renowned private foundation is the Bill and Melinda Gates Foundation.

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Registration as a Charity

An organization can register itself as a charity with the CRA provided it can show that it devotes all of its resources to charitable activities to further its charitable purposes.

The purposes and activities of the organization must meet a **public purpose test**, as follows:

- Its purpose and activities must be of measurable benefit to the public;
- The people who benefit must be members of the public as a whole or at least a significant portion of it.

The latter requirement excludes social clubs, professional organizations, or any organization that limits its beneficiaries unreasonably.

EXAMPLE

A foundation that provides university scholarships only for children of employees of one employer cannot be registered as a charity. Why? The potential beneficiaries of this foundation's activities are too limited in scope.

Application for registration as a registered charity is made to the CRA using form T2050 – Application to Register a Charity under the ITA.

Charitable Activities

An organization or foundation can qualify to be registered as a charity provided its purposes are exclusively charitable and it engages in **charitable activities** that support such **charitable purposes**.

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For purposes of registration, the following four categories of activities, with some examples, are considered charitable:

1. Relief of Poverty

- Establishing a food bank for the poor;
- Providing subsidized housing for low-income individuals and families;
- Disaster relief.

2. Advancement of Education

- Building and/or operating schools;
- Providing scholarships and bursaries;
- Providing educational programs for minority cultures.

3. Advancement of Religion

- Establishing/maintaining buildings for worship (e.g. churches, mosques, and synagogues);
- Providing religious instruction;
- Conducting missionary work.

4. Other Purposes Beneficial to the Community

- Providing facilities for the care and/or rehabilitation of the elderly;
- Providing/maintaining hospital facilities;
- Operating an animal shelter.

Benefits of Registration

Although an organization or foundation with charitable objectives does not have to be registered with the CRA in order to carry out its objectives, registration provides the following benefits:

- The organization can be exempt from regular income taxation, although there are other filing requirements;
- The ability to issue official donation receipts to donors who can claim the non-refundable donations tax credit, reducing taxes otherwise payable by the donor. This reduces the after-tax cost of the donation for the donor.

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EXAMPLE

Ariel donates $5,000 to a local community association in addition to the $1,000 she donates annually to her church. If the community association is not registered as a charity, the net after-tax cost of Ariel's $5,000 donation will be $5,000. If it is registered as a charity, the 29 percent federal donations tax credit (15 percent on the first $200) alone will reduce the after-tax cost of the donation less costly to Ariel.

Alternatively, if Ariel's intention is to spend $5,000, the value of her gift could be magnified to about $7,000 if the organization is a registered charity. The federal tax credit of 29 percent reduces the cost of $7,000 by approximately $2,000 ($7,000 x 29 percent). In addition, on Ariel's province of residence, reducing the after-tax cost below $5,000. Effectively, with the combined federal and provincial donation tax credit, Ariel could target an amount even higher than $7,000 if her after-tax cost is $5,000.

Decisions about the magnitude of a gift and whether to donate to a registered or non-registered charity are often influenced by the value of income tax incentives available to the donor. Other tax considerations include:

- Registered charities can receive gifts from other registered charitable organizations and foundations;
- Many goods and services provided by registered charities are exempt from GST/HST.

Obligations

Once a charitable organization is registered, it assumes the following tax-related obligations:

- Tracking disbursement quotas year over year;
- Completing and filing annual information returns; and,
- Preparing and maintaining books and records to standards established by the federal government.

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Revocation of Charitable Status

The CRA can revoke an organization’s charitable status should the organization fail to continuously comply with the requirements for maintaining charitable status as set out in the ITA.

Examples of reasons could include:

- Supporting terrorist activities;
- Defrauding contributors or the government;
- Repeated failure to meet disbursement quotas;
- Providing fraudulent information to the CRA;
- Issuing false receipts.

On January 1, 2012, new legislative provisions (ss. 149.1(1)) related to “**ineligible individuals**” came into force, giving the CRA authority to refuse or revoke the registration of a registered organization and/or to suspend receipting privileges. In situations where an individual on a board or in a management or control position is considered an “ineligible individual,” the CRA’s authority provides powers to protect the Canadian public.

In general terms, an ineligible person is one who has been convicted of an offence, including financial dishonesty or an offence that may be relevant to the organization’s operation.

Additionally, this new status applies to individuals who have been involved in a management or oversight capacity of another registered charity that has experienced a serious breach of the ITA requirements in the past. Ineligible individuals are not prohibited from being involved with registered charities; rather, the legislation is designed to provide the CRA with the power to address difficult situations that may arise.

There remains a great deal of uncertainty for charities as to how they should adjust to ensure they are in compliance with this legislation. For example, the CRA has indicated that it does not expect charities to undertake background checks of board members or directors. Yet, the CRA has the power to impose serious actions should a charity be out of step with the CRA’s expectations.

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Disbursement Quotas

The primary function of the **disbursement quota** is to ensure that charities use donations for their intended charitable activities. The disbursement quota ensures funds are not used inappropriately for excessive fundraising expenses, over-compensating senior management, or accumulating non-charity related assets. Expenses such as fundraising and manager salaries do not qualify as disbursements for the purposes of the quotas.

Requirements

The ITA generally requires all charitable entities to spend a specified percentage (3.5 percent) of their investment asset base in the following year. This is known as a disbursement quota. Failure of a charity to meet its disbursement quota on an ongoing basis can result in revocation of an organization's charitable status.

Base for the Disbursement Quota

The base on which the disbursement quota is determined differs slightly depending on the nature of the charity. The following is a summary:

- Charitable organizations must disburse 3.5 percent of the 24-month average of their investment pool if the average is greater than $100,000 in the prior year.
- Public and private foundations must disburse 3.5 percent of the 24-month average of their investment pool if the average is greater than $25,000 in the prior year.
- The 24-month average is based on when the charitable entity values its assets. The entity can choose from two to eight periods over the 24 months. For example, a charity could use two 12-month periods (annually) or perhaps eight three-month periods (quarterly) when determining the average for this calculation. Any other period between these two examples is also acceptable.
- The base for the calculation excludes those assets owned by the charity that are not devoted to charitable activity. For example, the building from which the charity operates would not be included, while a building held as an investment would be included.

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EXAMPLE

In 2019, the ABC Charity in Sometown, Ontario, received $327,300 in cash and other donations from the congregation and the church's national committee. In addition, the church held investment assets not devoted to its charitable activity, but which averaged $1,000,000 over that period 2017 and 2018.

As a charitable organization, the church must disburse at least 3.5 percent of its average investment assets. This means they must disburse $35,000 in 2019 ($1,000,000 x 3.5 percent).

Charitable Donors

Charitable giving is often an important part of a client's tax, retirement, and estate plan. In addition to straightforward donations of cash to charities, there are a variety of other strategies for making tax-effective donations, including the gifting of securities in-kind to a registered charity, donations made through a private corporation, and donor advised funds.

Income Tax Credit[23]

The Canadian federal and provincial governments provide significant assistance to charities through tax incentives that encourage Canadians to donate to registered charities. The impact of the **charitable tax credit** is to lower the after-tax cost of a charitable gift for individual Canadians.

[23] Excerpt from *COMMENT, Sept/Oct 2016*

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The 2019 federal tax credit on gifts over $200 is 29% for individuals with taxable income up to $210,371. When an individual's taxable income is greater than $210,371, the federal tax credit becomes 33% on the lesser of taxable income in excess of $210,371 (2019 amount) and the amount of the gift in excess of $200.

The traditional rule of thumb that gifts over $200 receive credit at the top tax bracket no longer applies unconditionally. While a number of provinces continue to offer the tax credit at their top tax bracket, the federal and a number of provincial governments no longer utilize the top tax bracket in the formula when calculating the applicable credit for the majority of taxpayers. As noted above, the federal credit for donations over $200 is capped at 29% for all taxpayers whose taxable income is less than $210,371. The top federal bracket of 33% is utilized only for credits in respect of individuals whose taxable income exceeds the 33% threshold and is applied as a unique formula.

EXAMPLE ONE

Margaret makes charitable donations that total $1,000 in 2019. Her 2019 taxable income estimated to be $100,000.

Margaret's federal tax credit is $262 [$30 + 232, derived as ($200 x 15%) + (($1,000 - $200) x 29%)].

EXAMPLE TWO

Tom makes charitable donations of $25,000 in 2019 and has estimated taxable income of $350,000 for 2019.

Tom's federal tax credit is $8,214 [$30 + 8,184, derived as ($200 x 15%) + ($24,800 x 33%, which is the lesser of taxable income in excess $210,371 and the amount of the charitable gift in excess of $200)].

Donations to a registered charity in Canada are eligible for the non-refundable donation tax credit, either in the year the donation is first made or in one of the five subsequent tax years.

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Inter Vivos Charitable Gift Limit

Charitable donations up to 75 percent of net income qualify for the calculation of the credit in a year. Unclaimed or unused amounts may be carried forward for five years.

Gift In-Kind

When the donation is a **gift in-kind** of capital property, the 75 percent limit is increased by 25 percent of any realized taxable capital gain or recapture of CCA associated with the disposition.

EXAMPLE

John owns an apartment building, which he bought for $1,000,000 many years ago. Over the years, John has claimed $125,000 of CCA. The apartment building is now worth $2,000,000 and he wants to donate it to his favourite charity.

Donating the building will trigger a disposition for John. He will realize a $500,000 taxable capital gain ($2m - $1m) and $125,000 recapture of CCA for a total net income of $625,000.

John's donation limit will be 75 percent of his net income ($468,750) plus 25 percent of the income realized on the disposition ($156,250 derived as 25 percent of (500,000 + 125,000)) for a total of $625,000.

To summarize, John will have a $1 million charitable gift receipt. He will have personal income of $625,000 related to the disposition of the building ($500,000 capital gain and $125,000 recapture). He can claim up to $625,000 of the charitable receipt plus 75 percent of any other net income he reports in that taxation year. For any portion of the $1 million receipt not claimed in the year of the gift, John can be carry it forward and claim it in any of the five subsequent taxation years.

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Corporate Donor

A **corporate donor** is entitled to deduct charitable donations up to 75 percent of its net income.

Donation of Appreciated Securities to Charity

The capital gains inclusion rate is reduced from 50 percent to 0 percent for gifts of publicly traded securities, including mutual funds and segregated funds, to charitable organizations, public foundations, and private foundations.

EXAMPLE

Mark and Jennifer want to make a $5,000 donation to their favourite charity. They decide to donate their XYZ Insurance Company shares, which have an ACB of nil because the shares were received on the demutualization of XYZ Insurance Company. The after-tax value of these shares is about $4,000, assuming a marginal tax bracket of 40 percent ($5,000 proceeds less tax on $5,000 capital gain).

They will pay no capital gains tax on donation of the share but will still be entitled to the $5,000 tax receipt for the amount contributed. The charitable receipt will generate about $2,500 of tax savings, assuming a 50 percent charitable tax credit.

The result of this donation is that Mark and Jennifer have completed their $5,000 donation by giving up XYZ shares that were only worth $4,000 to them, and they recovered about $2,500 in tax savings for a net cost of $1,500.

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Corporations

Similar to individuals, corporations do not realize a capital gain on the disposition of appreciated public company shares donated to a charity. However, the corporation continues to receive a credit to its capital dividend account equal to the untaxed portion of the capital gain.

EXAMPLE

Anne, who lives in Manitoba, decides to cause her corporation to donate $250,000 of publicly traded shares of a demutualized company (nil ACB) to her new charity.

The donation of these shares will entitle the corporation to a charitable receipt in the amount of $250,000. The taxes saved by the corporation will depend on the amount of its net income and the type of income. Active business income is taxed at 9 percent of the first $500,000 and 27 percent thereafter, and passive income is taxed at 50.67 percent (2019 amounts).

The corporation receives a CDA credit of $250,000 (i.e., $250,000 proceeds less nil ACB). In this case, the untaxed portion of the capital gain is $250,000. This CDA credit can then be paid out as a tax-free dividend to its shareholders.

The CDA dividend is worth about $115,000 in tax savings to Anne, assuming an effective marginal tax rate of 46 percent (2019 amount) on ineligible dividends.

It has also become easier in recent years to donate in-kind, especially when dealing with a major charity. Most brokerage firms have a special form to facilitate this type of transfer, while many charities have streamlined their procedures to ensure in-kind donations can be made with great ease.

Donor-Advised Funds

Private foundations can be expensive to set up and maintain. A **donor-advised fund** is a cost- effective alternative to establishing a private foundation.

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Essentially, a donor-advised fund piggybacks on a public foundation (such as a community foundation or a foundation established by a major financial institutions or investment management firm) by permitting the donor to create a "mini-foundation" as a subset of the larger, public foundation.

The donor makes a gift to the foundation and the foundation agrees to manage the capital and ensure that all of the paperwork is completed accurately and on time. The donor retains the right to dictate how much is donated annually and specifies the charities that are to benefit from the gifts.

The donor can give cash or assets, keeping in mind the significant tax advantage associated with donating appreciated securities. He or she receives a tax receipt equal to the FMV of any gift. The advantage of donor-advised funds is that the donor reaps the tax benefit today and is able to set up a fund that can carry on charitable work for a long period of time. The funds could grow inside the donor-advised fund tax-free, and the donor can recommend each year that distributions be made to any registered charities he or she chooses.

The funds inside the donor-advised fund are pooled with all other donors' funds and invested by professional money managers. Another advantage of these arrangements is that the donor is not burdened with administrative or record-keeping tasks, and the foundation reports regularly to the donor. The donor can appoint his or her children or other individuals as successors, enabling them to continue to oversee the donation arrangement after the donor's death.

An important distinction between these foundations is whether or not the donor is entitled to gift some or all of the capital donated. Some foundations determine how much the donor is allowed to gift annually. The formula is based on net investment income and a holdback for inflation. Some foundations allow the donor to gift some or all of the donated capital to a charity.

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Donation of RRSPs/RRIFs

The rule that eliminates the capital gains tax on donation of securities does not apply when a taxpayer donates appreciated securities held inside an RRSP or RRIF. When funds are withdrawn from these plans, the FMV of the withdrawal is immediately taken into income at full marginal rates.

However, there is a tax-effective way to donate funds in an RRSP or RRIF to a charity. The strategy involves naming the charity as the beneficiary of the RRSP or RRIF. Alternatively, instructions can be left in a will to donate an amount equal to the value of the RRSP or RRIF taxed on the terminal tax return.

A charity can issue a **charitable gift receipt** for donations received by way of beneficiary designation or amounts given from an estate.

Testamentary Gifts

Charitable gift planning is a part of many estate plans. A testamentary gift could be as simple as a bequest of cash or could involve a more sophisticated strategy.

From an income tax perspective, a testamentary gift is made the moment the gift or property is transferred to the charity. The gift could be direct from the estate or may arise from a beneficiary's right under a life insurance policy, RRSP, RRIF, or TFSA.

Final Return

Gifts made by the deceased or the deceased's spouse or common-law partner in the year of death may be claimed by the executor on the deceased's final return for an amount up to 100 percent of the deceased's net income in the year of death.

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To the extent that either the deceased or the deceased's spouse or common-law partner made a gift in a prior year but within the five-year carry forward period, any unclaimed portion of the gift may be claimed on the deceased's final return for an amount up to 100 percent of the deceased's net income.

While it has been the CRA's administrative policy to allow spouses and common-law partners to pool gifts and claim on one return, this is now specifically mentioned in the ITA, as described above.

Graduated Rate Estate

Below is a summary of how the donation tax credit may be utilized when made through a will or estate, while the testator's estate qualifies as a graduated rate estate (GRE), and when a gift is made by a direct beneficiary designation under a life insurance policy, RRSP, RRIF or TFSA. An estate may qualify for GRE status for up to 36 months following an individual's death.

a) The gift may be claimed by the executor on the deceased's final return for an amount up to 100 percent of the deceased's net income in the year of death.

b) The gift may be claimed by the executor on the deceased's return for the year preceding death for an amount up to 100 percent of the deceased's net income for that particular year.

c) The gift may be claimed on the estate's tax return for the tax year in which the gift was completed. In this case, the amount of the donation claimed is limited to 75 percent of the estate's net income for that particular year.

d) The gift may be claimed on the estate's return in any of the five subsequent taxation years for an amount up to 75 percent of the estate's net income for the year it is claimed. This means that gifts made in the third year of the estate's GRE status may be claimed by the estate in the subsequent years when the estate no longer qualifies as a GRE.

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e) A gift may be carried back to a preceding year of the estate. Aggregate gifts for that year are limited to 75 percent of the estate's net income.

Gifts that occur through a beneficiary designation must be completed during the existence of the GRE and must have occurred as a consequence of the deceased's death.

If a gift is completed by an estate after its GRE status has expired, but within 60 months of the deceased's death, the executor may claim the donation as outlined in (a) through (d) above. These options are available only if the estate remains in existence.

Gifts In-Kind

A testamentary charitable gift may be completed through a cash payment to the charitable entity or could be designed as a gift-in-kind.

It is common for a will to provide instructions that direct the executor to complete a particular gift or to provide latitude for the executor to determine how best to fulfil a charitable bequest. By providing this flexibility, an executor may determine the optimal distribution taking into account all assets owned at the time of death, the charitable objective, liquidity of the estate, amounts owing to all beneficiaries of the estate, and the income tax consequences.

Publicly traded securities are afforded special income tax treatment when donated as a gift-in-kind. In this case, there is no realization of a taxable capital gain, but the estate still receives a charitable donation receipt for the FMV of the securities. By donating the shares as a gift-in-kind, the executor can achieve a more efficient result for the estate when compared with disposing of the shares, paying the tax and then donating the after-tax cash to the same charity.

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EXAMPLE

Consider the example of Sam who passes away owning an investment portfolio valued at $1,000,000 with an ACB of $750,000. Sam's executor would report a $250,000 capital gain ($1,000,000 less $750,000) on Sam's final tax return. Assuming a 50 percent marginal tax rate, Sam's estate would incur an income tax liability of $62,500 on the taxable capital gain arising from the deemed disposition.

Assume that Sam wanted to make a $1,000,000 donation to his favourite charity. If Sam's instructions in the will provide for a donation of the shares to the charity or provided the executor with the authority to complete the bequest with a gift-in-kind, the estate would save $62,500 in income taxes.

In either scenario, a cash donation of $1,000,000 or a gift-in-kind of the shares valued at $1,000,000, the estate is entitled to a charitable tax receipt of $1,000,000. If the $1,000,000 of cash required to fulfil the bequest is achieved through the actual disposition of the shares, the estate would have a tax bill of $62,500 and would need to supplement the donation with other liquid assets to complete the $1,000,000 gift (disposition of shares resulted in liquidity of $937,500). If the bequest if fulfilled as a gift-in-kind, the executor would refile Sam's final tax return to remove the $250,000 capital gain, as the gift-in-kind attracts a zero income inclusion rate and would provide for the return of $62,500 through a reduced income tax liability.

Life Insurance

Life insurance can be integral to a variety of charitable gift planning strategies. Some individuals purchase life insurance because it allows them to make a charitable bequest without depleting their estate's assets. Others utilize life insurance to magnify the size of a charitable gift.

A common charitable strategy is to gift a new or existing life insurance policy to a charity, whereby the charity becomes the owner and beneficiary of the policy. The charity can generally issue a charitable receipt for the FMV of the policy at the time the policy is transferred and for any premiums paid by the donor on behalf of the charity after the transfer.

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As beneficiary of the policy, the charity receives the death benefit paid at the time of the life insured's death.

EXAMPLE

Consider the example of Martha who owns a life insurance policy on her life that she no longer requires as part of her estate plan. Rather than surrender the contract, Martha could donate the contract to her favourite charity. She would receive a tax receipt from the charity for the FMV of the policy at the time of transfer and any future premiums she might pay towards the policy. Martha would also incur a tax liability if the cash surrender value of the policy exceeded its adjusted cost basis at the time of the gift. Typically, the savings generated from the donation will more than compensate for this liability, but is nonetheless a factor that should be considered at the planning stage.

Upon Martha's passing, the charity would receive the insurance proceeds as the beneficiary of the policy. Since Martha relinquished ownership of the policy, her estate is not entitled any of the proceeds nor a receipt for the proceeds of the insurance paid to the charity.

Another charitable gift planning strategy using life insurance involves an individual retaining ownership of an insurance policy but naming a charity as the beneficiary for all or a portion of the death proceeds. At the time of the individual's death, the charity will issue a charitable receipt for the value of the proceeds received as a beneficiary of the policy. In addition to addressing an individual's charitable objectives, this strategy can be useful when individuals anticipate a large income tax liability upon their death and opt to use a charitable gift to offset some or all their income tax liability.

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EXAMPLE

Consider the example of Matthew and Marisa who jointly own a joint last-to-die life insurance policy on their lives. The couple have decided to use the policy for the benefit of their favourite charity. Matthew and Marisa could name the charity as beneficiary of the policy, while retaining ownership.

Given that the couple continue to retain ownership of the policy, they will not receive any charitable receipts during their lifetime. However, upon the latter death of Matthew and Marisa, the charity would receive the insurance proceeds and the estate of the last-to-die would be entitled to a charitable receipt equal to the insurance proceeds. The charitable tax receipt will generate a charitable tax credit that, as intended in their estate plan, will offset the income tax liability arising on the death of the last-to-die. Under this strategy, the charity would have to receive the proceeds of the life insurance policy during the period when the GRE existed in respect of the last-to-die.

The benefits of testamentary charitable gift planning can be rewarding for both the donor and for the charity who receives the benefit of a testamentary gift. There is no single strategy that applies across all donors, but rather plans can be designed to address an individual's personal and financial objectives.

Gifts Involving Insurance Policies

There are two primary planning strategies involving life insurance policies. The donor could give a new or existing policy to a charity, or the donor could name a charity as the beneficiary of a policy.

Generally, the gift of the life insurance policy results in a charitable gift being recognized for an amount equal to the FMV of the policy. There are, however, two exceptions to this rule of thumb - if the policy was acquired in the last three years, or if it was acquired within the last 10 years and it is reasonable to conclude that one of the main purposes for acquiring the property was charitable giving. Falling within one of these two exceptions means the value of the charitable gift is recognized at the policy holder's cost.

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A policy’s adjusted cost basis is available from the insurance carrier. Determining the FMV of an existing policy can be complex and typically should be established by a qualified professional who will consider information specific to the policy.

The gift of an existing life insurance policy to a charity is eligible for a charitable gift receipt equal to the FMV of the policy. When using this strategy, the disposition of the policy is deemed to have occurred at CSV. This has significant implications for the gifting of in-force policies, as the FMV may significantly exceed the CSV of the policy.

To the extent the donor commits to paying the premium under the charity-owned life insurance policy (new or existing policies), the charity is able to issue a charitable gift receipt annually for such payment. This strategy is good for those clients who can benefit from the annual claim for the charitable gift and want to leave a sizable gift upon their passing.

Alternately, the donor could retain ownership of the policy, pay the premiums annually, and name the charity as the beneficiary under the policy. In this case, the charity can issue a charitable gift receipt for the death benefit received. It should be noted that premiums are not tax-deductible to the policy owner.

Determination of Fair Market Value

There is a rule that states the FMV is deemed to be the **donor’s original cost** has been recently implemented. While this change arises because of the art-flip tax strategies, it can have implications for the donation of life insurance policies.

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Subsection 248(35) of the ITA stipulates that if one of the following statements is true, the FMV of the gifted property is deemed to be the lesser of its FMV otherwise determined and its cost; or, in the case of capital property, its ACB immediately before the gift is made:

a) The taxpayer acquired the property that is the subject of the gift under a gifting arrangement that is a tax shelter within the meaning assigned by section 237.1(1).

b) **(i)** The taxpayer acquired the property that is the subject of the gift less than three years before the day that the gift is made (except if the gift is made as a consequence of death).

c) **(ii)** The taxpayer acquired the property that is the subject of the gift less than 10 years before the day that the gift is made (except if the gift is made as a consequence of the taxpayer's death) and it is reasonable to conclude that, at the time the taxpayer acquired the gifted property, one of the main reasons for its acquisition was to make the gift.

Exclusions

Subsection 248(37) excludes several types of gifts from application of subsection 248(35), including:

- Gifts of inventory;
- Gifts of real property situated in Canada;
- Gifts of cultural property;
- Gifts of certain shares.

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Implications of the Deeming Rule

The following two scenarios set the stage for analyzing the implications of this new deeming rule.

Scenario 1: An individual who is a business owner acquires a life insurance policy on his own life to cover his taxes at death. Two years after acquiring the policy, he sells his business and pays the taxes resulting from the sale. Less than three years after acquiring the life insurance policy, he gifts it to a registered charitable organization.

Scenario 2: An individual who is aware that the cost of life insurance increases with age decides to purchase a life insurance policy with the intention of gifting it later to a registered charity.

After holding the policy for eight years, he creates a private charitable foundation and gifts his policy to the foundation, which is a registered charitable organization. He will continue to pay the premium each year.

In both scenarios, the life insurance policy is fully assigned to a qualified donee and the donee becomes the policyholder and beneficiary. The CRA's view is that subsection 248(35) of the ITA will apply to establish the FMV of the gifted life insurance policy in the two scenarios described. Consequently, it may be possible that the value of the policy for the purposes of a donation may be assessed at a value much lower than its cash surrender value.

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Taxation of Retirement Plans

The purpose of this section is to expand on the knowledge gained during the education process in working towards the CFP designation. The objective is to provide information in respect to the government, group, and individual programs/products that can provide retirement income, highlighting the basic rules, and the taxation at retirement as well as death.

Government

- Canada/Québec Pension Plan (CPP/QPP);
- Old Age Security (OAS);
- Guarantee Income Supplement (GIS).

Group

- Employee Profit Sharing Plan (EPSP);
- Deferred Profit Sharing Plan (DPSP);
- Registered Pension Plan (RPP);
    - Defined benefit;
    - Defined contribution;
- Individual Pension Plan (IPP);
- LIF, LRIF, PRRIF;
- Retirement Compensation Arrangement (RCA).

Individual

- Registered Retirement Savings Plan (RRSP);
- Registered Annuity;
- Registered Retirement Income Fund (RRIF);
- Tax-Free Savings Account (TFSA).

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Canada/Québec Pension Plan

The **CPP/QPP** is a public pension program funded with annual contributions from workers and employers. The programs track pensionable employment and contribution years to determine a pension benefit.

An individual's retirement benefit can be enhanced if the individual continues to work after electing to begin CPP/QPP retirement benefits. This is the **Post-Retirement Benefit** program.

The retirement benefit can be shared with an individual's spouse or common-law partner. The sharing would be based on pensionable employment during the years together and the retirement benefit would be split at source.

CPP/QPP retirement benefits are taxable in the year of receipt and are taxable to the hands of the recipient. When a shared CPP benefit amount is received by a spouse or common-law partner, it is taxable income to the recipient spouse or common-law partner.

The final CPP/QPP monthly retirement benefit is paid in the month of death. If the last monthly retirement benefit is received before the date of death, it is included in the deceased's terminal tax return. If the last monthly payment is received after the date of death but before the end of the month, the amount may be declared on a rights or things tax return for the deceased or included on the deceased's terminal return.

The CPP/QPP programs pay a **death benefit** in respect of a deceased contributor. The death benefit is normally taxable to the estate; however, there is an option that allows the amount to be taxed in the hands of the beneficiary. The choice of taxing the death benefit in the estate versus the hands of the beneficiary will typically depend on tax bracket management and on the premise that the beneficiary would be the recipient through the will.

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Old Age Security & Guaranteed Income Supplement

Old Age Security (OAS) and **Guaranteed Income Supplement (GIS)** are federally funded social security programs designed to augment the income of lower- and middle-income Canadian residents. OAS is based on years of residency in Canada. GIS is based on three factors: marital status, whether the spouse is receiving benefits, and income.

OAS benefits received are taxed as received.

GIS benefits are not taxable. However, GIS amounts received are reported on the personal tax return as part of total income and are later deducted in calculating net income.

Both OAS and GIS are subject to a **clawback** (reduction) that begins at a specific threshold amount and applies on each subsequent dollar of income until the entire benefit is repaid. In order to avoid double taxation, the OAS clawback becomes a deduction in the calculation of net income.

2018 Figures	OAS	GIS
Threshold – clawback begins at this income level.	$75,910	$18,216 – single status
Tax on excess	15%	50%

EXAMPLE

Seventy-year-old John is receiving the maximum OAS and his total income in 2018 was $85,910.

John's OAS clawback is the lesser of OAS received ($7,200) and 15 percent of $10,000 ($85,910 less $75,910), which is $1,500.

To summarize, John's 2018 OAS clawback is $1,500, which will be payable when he files his 2018 income tax return.

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If an individual files a late application for OAS benefits, the first payment could include retroactive benefits for up to 11 months, and the entire amount would be taxable in the year received.

OAS and GIS retirement benefits are not paid in the month following death.

Employee Profit Sharing Plan (EPSP)

An **Employee Profit Sharing Plan (EPSP)** allows an employer to share business profits with its employees, either all employees or a designated group of employees. The vesting provision of an EPSP are often used by an employer as a "golden handcuff" to encourage valuable staff to remain with the firm for a specified time period or until certain goals have been achieved.

There is no statutory provision that dictates the vesting period of an EPSP, which is stated in the plan provisions. It is not necessary to register an EPSP with the CRA, so there are no restrictions on the amount that can be contributed or how plan funds are invested.

There are no contribution limits in respect of an employee; however, when an employer's contribution is allocated (paid) in respect of a specified employee and it exceeds a certain threshold (excess EPSP amount), a tax is payable by the employee on the excess amount. The excess EPSP amount was introduced in the 2012 budget with the objective of creating greater equity. A **specified employee** is one who has a significant equity interest in the employer or who does not deal at arm's length with his or her employer.

EPSP Contributions

Employer contributions are calculated based on company profits and are paid to a trustee to be held for the benefit of plan members or are distributed to members directly. Contributions are tax-deductible to the employer. Employee contributions are permitted and are sometimes required.

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Taxation of EPSPs

For an employee, there is no tax advantage to participating in an EPSP. All contributions, income, and capital gains or losses must be allocated to the employee annually, and this income is taxable to the employee in the year allocated, whether paid out immediately or held until a future date (i.e. an employee may have to pay tax before actually receiving EPSP income).

All contributions allocated to the employee are taxable as employment income. Income earned in the trust and allocated to the employee retains its character for tax purposes. Such investment income could include some or all of the following:

- Dividends from Canadian corporations;
- Interest;
- Non-business foreign source income;
- Realized capital gains and losses.

Taxation Upon Retirement

Amounts withdrawn from the EPSP by employees are not taxable because the employee will have already paid tax on the allocations and income earned.

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EXAMPLE

ABC Corporation sets up an EPSP for its executive class of employees and commits to setting aside 1 percent of pre-tax profits annually. The vesting provision states that annual allocations are vested after five years.

If ABC's profits were $10,000,000, then ABC would contribute $100,000 to the EPSP and allocate the contribution to the executive group, each of who includes the allocated amount in his or her income.

If the EPSP earned investment income of $1,000 interest, $1,200 dividends, and $1,400 realized capital gains, this investment income is allocated to the plan members who are each responsible for tax on the amount allocated to him or her.

In year six, the executives would be entitled to draw out the $100,000 allocated to them five years earlier.

Occasionally, an employee pays tax on allocations that are eventually forfeited (i.e. employee leaves his or her job before the terms of the EPSP allow for a payout of the allocations). In this case, the ITA (subsection 144(9)) provides for an offsetting tax deduction that generally equals the amount forfeited under the plan. **Forfeited allocations** may be returned to the employer or allocated to other beneficiaries of the EPSP.

Taxation Upon Death

Upon death, the employee is liable for income tax on any allocation from the employer or allocation of investment return from the trust since the beginning of the year to the date of death.

If the plan allows for a beneficiary to receive the employee’s interest in the EPSP, that amount is received tax-free by that beneficiary.

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Deferred Profit Sharing Plan (DPSP)

A **Deferred Profit Sharing Plan (DPSP)** is a trust registered with the CRA that allows an employer to share profits from the business with either all or a designated group of employees. Contributions are tax-deductible by the employer and not taxable to the employee until paid out of the trust. Similarly, the income earned on the contributions is tax-deferred until paid out to the employee.

Beneficiaries

A DPSP can be set up by a sole proprietorship, partnership, or corporation; in all cases, the beneficiaries must be employees. This means a sole proprietor or a partner cannot be a beneficiary of a DPSP because they are not employees of their business.

This restriction extends to employees who are related to the sole proprietor or partner. In the case of a corporation, specified shareholders (those who own at least 10 percent of the shares of any class of the corporation) and their relatives are ineligible to be DPSP beneficiaries.

DPSP Contributions

Since 1991, only **employer contributions** from the current or prior years' profits are allowed. Employer contributions can be calculated as a percentage of profits or salary, or as a flat dollar amount per beneficiary. Contributions can also be made contingent on employee performance.

The only permitted contributions to a DPSP are employer contributions made under the terms of the plan as registered, for the benefit of the members under the plan, and direct transfers of lump-sum amounts from another DPSP.

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Contributions to a DPSP may be made by reference to profits (i.e. as a percentage of profits for the year) or out of profits (subsections 147(1) and (16) and IC77-1R4). If contributions are to be made out of profits, the formula may be expressed in various ways, and profits may be defined either as profits of the year or as undistributed profits of the year and prior years. Examples of out-of-profit formulas include a percentage of members' salaries or a fixed amount per member.

Employer contributions are limited to the lesser of 18 percent of the employee's compensation for the year and half of the **money purchase limit** for the year. The employer's contribution in respect of each employee is reported as a **pension adjustment** on the employee's annual T4.

Employers that provide both a registered pension plan and a DPSP have to ensure that the total pension adjustment does not exceed the lesser of 18 percent of the employee's compensation and the money purchase limit for the year.

DPSP Vesting

Amounts contributed to a DPSP are subject to immediate **vesting** once the employee has been a member of the plan for 24 consecutive months. It is possible to establish an earlier vesting date under the terms of the plan.

Amounts forfeited when an employee leaves the DPSP prior to becoming vested must be either paid out to the employee as taxable income or distributed to other members of the DPSP. **Forfeited benefits** are reported to the employee as a **Pension Adjustment Reversal** that reinstates the employee's RRSP room.

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Payments Out of a DPSP

Vested amounts must be paid out to the member by the earliest of:

- 90 days after the member's death;
- 90 days after the termination of the member's employment;
- 90 days after the termination of the plan; and,
- The end of the year in which the member reaches age 71.

Payments Before the Deadline

Payments can be made from the DPSP before this deadline, even where the member is still an active employee.

Funds in a DPSP may be transferred to another DPSP, RPP, or RRSP, used to buy an annuity, or withdrawn in cash or in-kind either in instalments or as a lump sum. Instalments must be paid in equal amounts, at least annually, over a period of not more than 10 years. Instalment payments are eligible for the pension income tax credit.

Amounts received from a DPSP are taxable in the year received, except for funds used to buy a life or term certain annuity or funds transferred directly to an RPP, RRSP, RRIF, or DPSP of the member or surviving spouse or partner.

Special Rules

Special rules apply when shares of an employer (or related) corporation are paid out of the DPSP in a single payment to the plan member. In this situation, the beneficiary can file an election under ss. 147(10.4) of the ITA, which serves to exclude the value of the shares from taxable income in excess of their cost amount to the DPSP until the taxpayer disposes of the shares, dies, or becomes non-resident. The cost amount of the shares can be transferred to another DPSP, RPP, RRSP, or RRIF to shelter the amount and future income from current taxation. The beneficiary makes the election by filing Form T2078 with the income tax return for the year he or she receives the shares.

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Income Tax Consequences

When an employee eventually disposes of the employer shares transferred from the DPSP, the following income tax consequences arise:

- Income equal to the value of the shares when transferred from the DPSP in excess of the cost of the shares to the DPSP at that time;
- The employee is entitled to a tax deduction equal to one half of the income inclusion; and,
- Capital gain equal to the excess of the proceeds of disposition less the value of the shares when they were transferred out of the DPSP.

EXAMPLE

After 30 years of service, Michael was entitled to $100,000 from the company's DPSP. Michael chooses to take his entitlement in-kind by requesting the transfer of company shares that were held in the DPSP as an investment. The shares Michael receives are valued at $100,000 with a cost base to the DPSP of $30,000. Michael eventually sells the shares for $150,000.

The following describe the tax consequences that Michael will realize:

- Michael is taxable on $30,000 (cost base to the DPSP of the shares transferred) at the time shares are transferred from the DPSP to Michael (assuming a 147(10.4) election).
- Michael is taxable on $70,000 (value of the shares in excess of the DPSP's cost at the time of transfer) when he sells the shares.
- Michael is entitled to a tax deduction of $35,000 in respect of the income inclusion at the time of sale.
- Michael recognizes a capital gain of $50,000 in respect of the disposition (proceeds of disposition ($150,000) in excess of the value when transferred from the DPSP ($100,000)).

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DPSP Employee Contributions

Funds held in a DPSP may represent a combination of employer and employee contributions from previous years (because employee contributions to a DPSP were allowed before 1991). In this case, amounts paid out of the plan can represent **non-deductible employee contributions,** which will not be taxable when withdrawn directly. However, if these funds are used to purchase an annuity, their tax-exempt status is lost and the funds are, in effect, subject to double taxation. Funds that represent a tax-free return of member contributions cannot be transferred to an RPP, RRSP, RRIF, or another DPSP.

Death of a Plan Member

Most DPSPs allow an employee to name a beneficiary to receive his or her interest upon death. If the named beneficiary is the estate or there is no beneficiary, the estate receives the employee's entitlement and is taxable on the amount received.

If the named beneficiary is the spouse, the plan trustee can make a direct transfer of employer contributions and any income attributable to employee contributions to an RPP, RRSP, RRIF, or DPSP of the surviving spouse or partner.

If the named beneficiary is someone other than the spouse, the benefit received is taxable to that recipient beneficiary.

Any employee contributions made to the DPSP flow through the plan member's estate and can be transferred indirectly to a surviving spouse or partner according to the terms of the member's will. Such amounts are not taxable to the estate or surviving spouse.

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Registered Pension Plans

Taxation of Retirement Benefits

The plan member will choose from a number of income options. The primary differences among the options are the number of guaranteed payments and the percentage of the monthly benefit the surviving spouse is entitled to receive when the plan member passes away.

Any payments received are taxable in the year received.

Taxation of Death Benefits

When the **named beneficiary** is the spouse of the plan member, the trustee can make a direct transfer to an RPP, RRSP, RRIF, or annuity of the surviving spouse or partner.

When the named beneficiary is someone other than a spouse, the benefit paid is taxable to the recipient. The deceased is not taxed on RPP death benefits paid to another individual.

If the named beneficiary is the estate, or if there is no named beneficiary, the estate receives the employee's entitlement and is responsible for the associated tax.

LIF, LRIF, PRRIF

A member of a pension plan may be entitled to transfer his or her benefits out of the pension plan into another program he or she controls. Provincial legislation dictates that the funds be transferred into a locked-in plan such as a Life Income Funds (LIF), Locked-in Retirement Income Funds (LRIF), or Prescribed Registered Retirement Income Funds (PRRIF) in Saskatchewan only.

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Taxation on Retirement

Any payments received under a payout plan are taxable in the year received.

Taxation on Death

If the named beneficiary is the member's spouse, the plan can continue for the benefit of the surviving spouse.

If the named beneficiary is someone other than the spouse, the commuted benefit is taxable to the individual named as beneficiary. The deceased is not taxed on the death benefit paid to another individual.

If the named beneficiary is the estate, or if there is no beneficiary, the estate receives the employee's entitlement and is taxable on the amount received.

Registered Retirement Savings Plan

A **Registered Retirement Savings Plan (RRSP)** is designed to provide income deferral opportunities for taxpayers who want to save for retirement. Tax is deferred on both the contributions and the income earned by funds held within the plan. An RRSP can be maintained up to the end of the calendar year in which the **annuitant** (the person who will receive the retirement income from the RRSP) reaches age 71; at that time, the plan is de-registered, and the funds may be withdrawn in cash, transferred to a RRIF, or used to purchase a life or term certain annuity to age 90.

The amount of RRSP contributions a taxpayer can deduct from income (known as **deduction room**) is limited to the lesser of 18 percent of the taxpayer's earned income for the previous year and the RRSP dollar limit for the current year.

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If the taxpayer is a member of a Registered Pension Plan or Deferred Profit-Sharing Plan, this limit is reduced by the Pension Adjustment of the previous year and any net Past Service Pension Adjustments for the current year, and increased by any Pension Adjustment Reversals for the current year.

Unused deduction room may be carried forward indefinitely and used in a future year. A taxpayer can deduct contributions made to his or her own RRSP up to the end of the year he or she reaches age 71. If a taxpayer over the age of 71 has a spouse younger than 71, contributions can be made to a spousal plan and deducted by the taxpayer.

Contributions do not have to be deducted in the year they are made. In some cases (particularly when a taxpayer has made a large "catch-up" contribution), there can be significant tax advantages to spreading the corresponding deduction over several years to shelter income that would otherwise be taxed at a higher rate.

Death of Annuitant

On the **death of an RRSP annuitant**, the value of the plan is usually included in the annuitant's income for the year of death. Where a surviving spouse or common-law partner is named in the RRSP contract as sole beneficiary, all of the RRSP property may be transferred directly to an RRSP, RRIF, or eligible annuity for the survivor on a tax-deferred basis.

Alternatively, the value of the RRSP is reported on the deceased's terminal return and the amount transferred to the surviving spouse or partner is deducted as a **refund of premiums**. The survivor reports the refund of premiums as taxable income, but can roll over any part of that amount to his or her RRSP within 60 days after the end of the year of receipt. In some cases, it can be beneficial from a tax perspective to bring some of the RRSP proceeds into income, either on the deceased's terminal return or on the survivor's return. For example, this may be advantageous if the RRSP income can absorb non-capital and capital losses, or medical expense credits that would otherwise be wasted.

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A refund of premiums may also be paid to a child or grandchild who was financially dependent on the annuitant at the time of death. Financial dependence usually requires that the child's income not exceed the basic personal tax credit for the year. In the case of a physically or mentally infirm dependent, the dependent's income is usually limited to the total of the basic personal tax credit and the disability amount. A dependent child who is under age 18 may use the refund of premiums to purchase a term certain annuity to age 18 to spread the tax liability out over that time. A disabled child or grandchild may roll the refund of premiums to an RRSP, life annuity; term certain annuity to 90, or a RRIF.

Marriage Breakdown

Where there is a **breakdown of a marriage or common-law relationship** and an equalization payment is required, a direct transfer may be made from one spouse's RRSP to the other's RRSP or RRIF on a tax-deferred basis. The transfer must be made pursuant to a court order or a written separation agreement.

Registered Retirement Income Funds

Registered Retirement Income Funds (RRIFs) is one of two retirement income vehicles available to the owner of an RRSP. While an RRSP must be collapsed by the end of the calendar year in which the plan owner reaches age 71, the RRSP can be collapsed and funds transferred to a RRIF at any point prior to this deadline.

In order for a Retirement Income Fund (RIF) to be registered under the ITA, it must satisfy certain conditions. Payments from the plan must begin no later than the first calendar year following the establishment of the plan, and a required minimum payment must be made from the plan each year.

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Taxation of Payments

Only the amount withdrawn or transferred out is included in taxable income. While the minimum required withdrawal is not subject to tax withholding at source, withholding does apply to amounts in excess of the minimum. Tax is payable on the total amount received (minimum amount and any amount in excess of the minimum). Withdrawals above the minimum amount are subject to the attribution rules that apply to spousal RRSPs.

RRIF payments to the annuitant aged 65 and older are eligible for the pension income tax credit. At the federal level, this credit is applied to up to $2,000 of eligible pension income each year.

However, if a RRIF owner is receiving employer pension income, which is also eligible for this credit, he or she cannot double up.

Pension Income Splitting

Up to 50 percent of payments paid out of a RRIF to the annuitant who has reached age 65 can be assigned to a spouse or partner and reported on that person's tax return.

Death of an RRIF Annuitant

On the **death of a RRIF annuitant**, the plan's value is included in the annuitant's income for the year of death unless there is a rollover to an eligible beneficiary or contingent owner.

Where the annuitant's spouse or common-law partner is named as the **contingent annuitant**, the plan is transferred tax-free to the surviving spouse and the RRIF payments continue in the name of the new annuitant.

Where the surviving spouse, common-law partner, or a financially dependent child or grandchild is the named beneficiary, all or a portion of the designated benefit may be transferred to the beneficiary on a tax-free rollover basis.

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Where the beneficiary is a child who is financially dependent, he or she may take the benefit in cash or buy a term certain to age 18 annuity. A child who is neither mentally nor physically infirm is considered financially dependent as long as his or her income does not exceed the basic personal amount for the year the benefit is received ($12,069 for 2019).

Where the beneficiary is dependent because of mental or physical infirmity, he or she may take the benefit in cash, transfer to an RRSP, or buy an annuity. The threshold for financial dependence is the total of the basic personal amount and the disability amount ($20,485 in 2019).

Minimum Required Withdrawal

Note that the **minimum required withdrawal** for the year is taxable on the deceased's terminal return, which may reduce the amount of the designated benefit that is taxable to the beneficiary.

EXAMPLE

Xiao passed away on October 1, 2018, the day before his 75th birthday, without having received his RRIF payment for the year. His RRIF was valued at $200,000 on January 1 and $210,000 on the date of death. Xiao's second wife and adult daughter were equal beneficiaries of the RRIF (50 percent/50 percent).

The following describe the tax consequences that Xiao will realize:

- The RRIF minimum is $15,420 ($200,000 x 0.0771 (the RRIF factor for age 74)).
- The half of the RRIF that was paid to his daughter is $97,290.
- ($210,000 – $15,420) ÷ 2)].
- Total income reported is $112,710. (RRIF minimum of $15,420 and amount paid to daughter that is not eligible for the rollover $97,290).
- The half of the RRIF ($97,290) paid to his wife qualifies for rollover treatment, which applies automatically unless the estate executor elects out.

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International

This module provides practitioners with a working overview of the tax environment and issues facing clients with international connections. The discussion is intended for awareness purposes and is not comprehensive. Clients should always consult with an expert in international tax law (lawyer or accountant) before making decisions related to issues identified in this module. This module is designed to help you identify these types of issues.

Planners need to be aware of Canada's taxation of individuals departing **(emigration)** Canada and the tax implications to those individuals entering **(immigration)** Canada.

US estate tax is a major consideration for clients holding US situs assets. Clients should be aware of potential estate tax liabilities and possible steps to reduce or eliminate this tax.

Entering Canada

Gains accruing before a person becomes a resident of Canada are subject to a **deemed acquisition rule** – all property owned by the taxpayer is deemed to be acquired at the time of becoming a resident of Canada. The FMV of the property at that time becomes the **Adjusted Cost Base (ACB)** for purposes of subsequent dispositions reportable in Canada.

EXAMPLE

Michael, a US resident, immigrated to Canada. At the time of immigrating, he owned a US stock portfolio with an FMV of $245,000 and an ACB of $180,000. Under Canadian tax law, Michael was deemed to have acquired the stocks at a cost of $245,000 (FMV at the time of emigration), which became the ACB for purposes of calculating future capital gains or losses on disposition for Canadian tax purposes.

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Properties Excluded from the Deemed Acquisition Rule

The following properties are not subject to the deemed acquisition rule, as they are generally subject to Canadian tax regardless of the owner's residence:

- Taxable Canadian property;
- Inventory of a business carried on in Canada;
- Eligible capital property of a business carried on in Canada.

Excluded rights or interests and statutory plans, including, among others:

- RRSPs, RRIFs, RESPs, DPSPs, superannuation and pension plans;
- RCAs, employee stock options, retiring allowances, annuity payments; and,
- Life insurance policies, other than a segregated fund policy, where the life insured was resident in Canada at the time of issue.

Taxable Canadian Property

Generally, the term **"taxable Canadian property"** includes the following:

- Real or immovable property situated in Canada;
- Property (including eligible capital property) used or held by the taxpayer in respect of, or property described in an inventory of, a business carried on in Canada;
- A share of the capital stock of a corporation (other than a mutual fund corporation) that is not listed on a designated stock exchange, an interest in a partnership, or an interest in a trust (other than a unit of a mutual fund trust or an income interest in a trust resident in Canada);

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- A share of the capital stock of a corporation that is listed on a designated stock exchange, a share of the capital stock of a mutual fund corporation, or a unit of a mutual fund trust, if, at any particular time during the 60-month period that ends at that time,
  - (i) 25 percent or more of the issued shares of any class of the capital stock of the corporation, or 25 percent or more of the issued units of the trust, as the case may be, were owned by or belonged to one or any combination of:
    - (A) the taxpayer, and
    - (B) persons with whom the taxpayer did not deal at arm's length;
  - (ii) more than 50 percent of the FMV of the share or unit, as the case may be, was derived directly or indirectly from one or any combination of real or immovable property situated in Canada, Canadian resource properties, timber resource properties;
- A Canadian resource property;
- A timber resource property;
- An income interest in a trust resident in Canada; and,
- A life insurance policy in Canada.

Other Considerations

For purposes of the deemed acquisition on immigration, the following assets are also considered taxable Canadian property:

- Canadian resource properties;
- Timber resource properties;
- Income interests in Canadian-resident trusts;
- Certain income rights of a retired partner;
- Life insurance policies in Canada, including segregated fund policies.

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Life Insurance Policies

A life insurance policy issued by a Canadian carrier on the life of a Canadian resident is exempt from the deemed acquisition rule and is subject to the Canadian policyholder tax regime.

Any other life insurance policy (including an annuity contract) owned at the time of immigration is deemed to have been acquired at its FMV, and this becomes the policy's initial ACB. From that point on, the foreign policy is also subject to Canadian tax reporting, including the calculation of gains on any disposition, and of accrual income where the policy is determined to be non-exempt. On a practical level, these requirements are difficult to meet for the following reasons:

- The determination of the FMV of a policy on a living person involves many factors.
- The income reporting calculations are complex and often involve information available only from the (usually foreign) insurer.
- Foreign insurers often lack the expertise to perform the Canadian exemption test.

Leaving Canada: Deemed Disposition

When a Canadian resident leaves Canada, he is generally deemed to have disposed of most assets for proceeds equal to their FMV at the time of emigration. At the same time, the former resident is deemed to have immediately reacquired the same assets for their FMV, thereby crystallizing the tax position.

This deemed disposition will result in an asset by asset disposition with each disposition resulting in a capital gain or loss and, in the case of depreciable property, a recapture or a terminal loss. The net taxable capital gain arising on the deemed disposition of qualified farm property or qualified small business corporation shares is eligible for the capital gains deduction.

The departing resident pays the resulting tax at the time of emigration unless he or she arranges with the CRA to defer payment until the assets actually are sold.

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In this case, suitable security must be provided to the CRA, and the Canadian tax payable remains fixed based on that point in time.

EXAMPLE

Sunny was a Canadian resident for tax purposes from 1995 until 2018. In late 2018, he emigrated out of Canada to seek employment in Brazil. At the time of emigration, Sunny owned Canadian securities with an FMV of $102,000 and an ACB of $47,000. He was deemed to have disposed of the securities for proceeds of $102,000 at that time and reported (paid tax on) a capital gain of $55,000 for 2018.

Life insurance policies owned by Canadian residents who emigrate from Canada are exempt from the deemed disposition rules. The policy owner continues to have a policy ACB the same as it was immediately before emigration, and no policy gain (if applicable) is reported on leaving Canada.

EXAMPLE

When Sunny (above) left Canada in 2018, he also owned a whole life insurance policy, which he retained. At the time of departure, the policy had a CSV of $12,000 and an ACB of $3,800. He was not deemed to have disposed of the policy at the time of emigrating (unlike the securities held). He did not have to report the policy gain of $8,200 on departure.

When a person emigrating from Canada owns shares in a corporation that owns life insurance policies, the valuation of the shares must reflect the corporate-owned life insurance policy. A life insurance policy on the life of the former resident (or a related party) is deemed to be valued at its CSV. However, any other corporate-owned life insurance policy is valued at FMV.

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EXAMPLE

Donna left Canada in 2018. At the time of departure, she owned shares in her brother's private corporation. The only corporate-owned life insurance policy was on Donna's life. It had a face value of $100,000 and a CSV of $7,300. When valuing Donna's shares for the purpose of the deemed disposition on her departure, this $7,300 is included in the asset value of the corporation.

Life Insurance Policies

For financial and estate planning purposes, the tax consequences with respect to life insurance in a foreign context are always a consideration. These scenarios include:

- Canadian life insurance policies owned by Canadian residents emigrating from Canada (individual is now non-resident of Canada); and,
- Life insurance policies from the former country owned by an individual immigrating to Canada (individual is now resident in Canada).

Non-Resident Owners of Canadian Life Insurance Policies

A policy is considered a life insurance policy in Canada if it insures the life of a Canadian resident at the time it was issued. When there is a disposition of a policy owned by a non-resident, the policy gain is taxed in the hands of the policy owner as Canadian income and taxed at graduated rates.

The non-resident may arrange for payment of the required tax or security and obtain a certificate for that payment (Form T2062B) under subsection 116(5.2). The person acquiring the policy (i.e. the insurer or purchaser) is liable for tax under subsection 116(5.3), equal to 50 percent of the amount payable to the non-resident in excess of the certificate amount, if any.

The tax may be withheld from the amount paid. If no certificate is provided, the non-resident will receive only half of the proceeds from the disposition of the policy.

Where the amount of tax prepaid by the non-resident exceeds the actual tax liability arising from the disposition of taxable Canadian property, a refund

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can be obtained by filing a Canadian income tax return for the year of the disposition. This includes tax in respect of a life insurance policy in Canada.

Canadian Residents Owning Foreign-Issued Life Insurance Policies

There are two issues with respect to a Canadian resident owning a life insurance policy issued by a foreign insurer. First, the policy is subject to Canadian tax rules, which means the policy owner will have to monitor exempt status and properly report dispositions. Second, a life insurance policy owned by a Canadian resident but issued in a foreign jurisdiction is subject to the foreign property reporting rules if the cost of the Canadian resident's interest in the policy exceeds $100,000.

US Estate Tax

The US imposes **estate taxes** on its citizens and residents based on the individual's worldwide assets. Citizens and green card holders are all considered in this calculation, no matter where in the world they live.

In addition, the US imposes estate taxes on non-resident aliens who hold assets situated in the US. A **non-resident alien** is defined as an individual who is not a resident or citizen of the US and is not a holder of a US green card.

Generally, **US situs assets** include (among others):

- Real estate or tangible property physically located in the US, including 100 percent of property owned by the deceased as joint tenant with rights of survivorship;
- Capital stock of a US corporation; and,
- Debt obligations (e.g. bonds, debentures, and loan instruments) issued by a US domestic corporation or trust.

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Calculation of US Estate Tax (Non-US Individuals)

Once the **gross value of the estate** (the FMV of the deceased's world assets) and value of US situs assets has been determined, the applicable US estate tax and tax rate can be established.

EXAMPLE

Fred and Martha, a married couple, own a condo in Arizona valued at $1,000,000 together with $2,000,000 in US securities. Their worldwide net worth is about $15,000,000. All figures are in US dollars. Fred and Martha are Canadian citizens and resident in Canada. Their US estate tax liability could be estimated as follows:

$3,000,000	Value of US situs assets ($US)
$15,000,000	Value of worldwide estate ($US)
$1,145,800	Tentative estimated US estate taxes
$883,560	Unified credit (greater of $13,000 and prorated $4,417,800)
$262,240	Estimated US estate tax before Marital credit
$883,560	Marital credit
$0	Estimated net US estate tax after Marital credit (if applicable)

The 2018 federal estate and gift tax limit is $11,180,000. The 2018 unified credit before proration is $4,417,800.

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Worldwide Estate

For US estate tax purposes, life insurance policies on the life of a deceased are included in the value of the deceased's gross estate if he or she held any **"incidents of ownership"** in the policy (i.e. owned the policy, held an option to acquire the policy, or had the right to control the policy directly or, for example, through a corporation that owned the policy in which he held 50 percent or more of the shares).

A policy on the life of a third-party is treated as US property for estate tax purposes and valued at its CSV at the date of death of the owner.

Planning to ensure that insurance proceeds are not included in the deceased's taxable estate would involve an irrevocable life insurance trust.

EXAMPLE

Angela, a Canadian resident who owns real property in the US, died on June 30, 2018. At the time of her death, Angela also owned four life insurance policies directly and one indirectly through her wholly owned private corporation.

- Policy A – Canadian policy owned by Angela insuring her life for $250,000 payable to her husband. The policy has a CSV of $22,000.
- Policy B – Canadian policy owned by Angela's Canadian private corporation insuring her life for $100,000 (as a key-person policy) payable to the corporation. The policy has a CSV of nil.
- Policy C – Canadian policy owned by Angela on the life of her son, George, insuring George for $50,000 and payable to Angela's spouse. The policy has a CSV of $12,000.
- Policy D – US-issued policy insuring the life of Angela's brother (a former business partner and a US resident) for $100,000 payable to Angela. The policy has a CSV of $9,500.
- For US estate tax purposes, the full face amount of insurance for policies A and B is included in determining the value of Angela's world estate, as is the CSV of policy C. The CSV of policy D will also be added to the value of Angela's world estate, but, because the policy is US property, the $9,500 CSV will also be included in the value of Angela's US assets and possibly be subject to US estate taxes.

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Deductions – Non-Resident Alien's World Estate

For the estate of non-resident aliens, a number of deductions are available that reduce the value of the individual's worldwide estate. The value of an individual's worldwide estate is used in the formula to calculate the unified credit. Examples of deductions include funeral expenses, outstanding non-recourse debts secured against US situs assets, estate taxes paid to a US state and gifts at death to a US registered charity (in the case of a US resident) or a Canadian registered charity (in the case of a Canadian resident).

EXAMPLE

Doug, a Canadian citizen and resident, died in 2018 while holding worldwide assets valued at $6,350,000. At the time of his death, he owned a $650,000 condominium in Arizona and a portfolio of US securities worth $850,000 (both included in his worldwide assets). His funeral expenses amounted to $10,000 and his will provided for a gift to a registered charity in the amount of $30,000. Accordingly, his worldwide estate for US estate tax purposes was valued at $6,310,000 ($6,350,000 – $10,000 – $30,000 = $6,310,000).

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US Estate Tax Schedule

The following table reflects the US estate tax rate schedule application from 2013 onwards and currently applicable (as of 2018).

From ($)	To ($)	Tax on "From" ($)	% on Excess
0	10,000	0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	And over	345,800	40%

Unified Credit

The **unified credit** for 2018 is $4,417,800 US dollars. This amount is adjusted annually. The Canada-US tax treaty provides that a Canadian who has treaty protection is entitled to a prorated portion of this credit. The proration is the value of US situs assets divided by the value of the worldwide estate.

Under US tax law, every non-resident alien is entitled to a credit of $13,000 US (i.e., $60,000 worth of US situs assets). The outcome is that a Canadian resident (who is covered by the Canada-US treaty) is entitled to the greater of the prorated credit and $13,000 US (US tax law).

EXAMPLE

Fred and Martha had $1,000,000 of US situs assets and a $20,000,000 worldwide estate. They are each entitled to 5 percent ($1,000,000/$20,000,000) of the unified credit, which is valued at $220,890 (5 percent of $4,417,800). This $220,890 credit is much greater than the standard $13,000 credit.

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Marital Credit for Canadian Residents

In lieu of the US marital deduction, a marital credit against US estate taxes otherwise payable may be available under the Canada-US tax treaty. The credit applies to property passing to the spouse of a deceased non-resident owner of US situs assets. The credit is the lesser of:

- The unified estate tax credit available to the estate;
- The amount of the estate tax otherwise owing on the property passing to the spouse.

To claim the credit, the following conditions must be met:

- The US situs property must pass to the deceased's surviving spouse;
- The property must be qualifying property;
- The deceased must have been a citizen or resident of the US or Canada;
- The spouse must have been a citizen or resident of the US or Canada.

Canadian Tax Credit for US Estate Tax

Under the Canada-US tax treaty, US estate taxes paid by non-resident aliens can be **credited against Canadian income taxes** owing on the same US property. The credit is the lesser of the US estate taxes paid and the Canadian income taxes owing on that property.

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EXAMPLE

Donna owns US assets with an FMV of $1,650,000 and an ACB of $1,200,000. At death, she is deemed to have disposed of the property for proceeds equal to the FMV resulting in a capital gain of $450,000 ($1,650,000 – $1,200,000 = $450,000). This means $225,000 ($450,000 x 50 percent) is added to her taxable income in Canada for the year.

At her marginal tax rate of 50 percent, it creates $112,500 ($225,000 x 50 percent = $112,500) of additional Canadian taxes owing.

Assuming she has US estate taxes of $177,524 owing, the $112,500 of Canadian taxes owing can be reduced by the US estate taxes paid, which means that Donna's estate would not have a Canadian tax liability in respect of her US situs assets.

Note that not all Canadian provinces have adopted the Canada-US treaty provisions that permit the foreign tax credit, so a reduction in provincial income tax may not always be available.

Foreign Account Tax Compliance Act

The **Foreign Account Tax Compliance Act (FATCA)** is US legislation that requires non-US financial institutions to report to the US Internal Revenue Service (IRS) financial information about American citizens who may be dealing with non-US financial institutions. FATCA is a US initiative designed to deter and identify tax evasion by US citizens. The significant leverage used by the US to force institutions and countries to comply is the threat of a significant withholding on business done in the US by financial institutions that do not comply. After extensive negotiations between the Canadian and US governments, agreements have been put in place whereby information captured by Canadian financial institutions is sent to the CRA. The CRA then transfers the information to the IRS.

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FATCA’s disclosure requirements necessitated extensive work by Canada’s financial institutions (and others around the world) in order to identify individuals and corporations to which the rules apply. Major changes and reporting have increased the workload and costs of meeting FATCA’s requirements.

Canadian financial institutions include banks and life insurance companies. An insurance broker is not classified as a financial institution.

Foreign Bank & Financial Accounts Reporting

Beyond FATCA, the US has the **Foreign Bank and Financial Accounts Reporting (FBAR)** legislation (FBAR) that requires every American citizen to disclose their financial interests in or signature authority in a foreign financial institution, as part of their annual filing of tax returns. This is similar to Canada’s rule with respect to the disclosure of foreign assets in excess of $100,000.

The FBAR rules work in conjunction with the FATCA to ensure full disclosure of the financial interests of American citizens in non-US financial institutions.

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Summary

After completing this module you should have gained a solid understanding of:

- Determining the taxation of a deceased individual and their estate and the potential tax filing requirements keeping in mind the need to refer the client to a tax professional to ensure compliance with all of the taxation regimes;
- The structure of registered charities and their obligations to comply with government regulations;
- Tax-advantaged strategies for making charitable donations during life and at death;
- The tax implications for registered vehicles at the times benefits are to be paid out, during life and at death;
- The taxation of a client's foreign holdings particularly U.S assets, understanding the need to involve tax and accounting professionals in this complex matter.

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Advanced Concepts in Tax & Law for Personal Planning

2019 Edition

This course focuses on advanced wealth transfer and estate planning strategies for individuals and their families. It builds on prior knowledge exploring advanced financial planning concepts with a focus on tax and legal considerations. Topics include advanced applications related to:

- Understanding Canada's legal system, income tax administration and the development of tax policy, which affects planning strategies
- Understanding the use of trusts and other instruments to ensure the orderly transfer of individual wealth
- Advanced applications related to the taxation of life insurance and living benefits
- Special tax reporting obligations facing individuals who enter or leave Canada
- Client objectives and responsibilities at death including tax and legal obligations and how they can be reconciled to the wealth transfer and estate planning intentions of the testator

Advanced Concepts in Tax & Law for Personal Planning is course five of a seven course program in the CLU designation program.

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