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COMMENT

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COLLATERAL INSURANCE

The Canada Revenue Agency (CRA) has delivered another reason to use individual insurance over creditor group insurance to secure business loans. In a recent technical interpretation letter, the CRA opined on the issue of the deductibility of payments for group creditor insurance.

Central to the issue is the wording of the legislation governing the deductibility of premiums on life insurance pledged as collateral. To be deductible, the premium must be "*payable by the taxpayer under a life insurance policy*." The CRA has indicated in an interpretation bulletin that the borrower must be the owner of the policy in order for the premiums to be "payable by" that taxpayer. Group creditor insurance is set up by the lender for its own benefit. Although the lender may charge the group premium through to the borrower, the lender is the owner of the policy. In such a situation, the group insurance premium would not be deductible by the borrower. From the lender's point of view, it would be considered to have been reimbursed for a non-deductible expense.

If the lender had instead charged the borrower for the group creditor insurance by way of an increased interest rate, the borrower would be able to deduct the cost (assuming the other requirements for interest deductibility have been met). The lender would have increased income from the higher interest rate charged and a non-deductible creditor group insurance charge.

To protect against the financial risk of a premature death, collateral insurance is an important consideration for any borrower. How the collateral insurance is structured can have important income tax considerations and, therefore, impact the after-tax cost of the insurance protection.

I/R 900.01

INSURED ANNUITY STRATEGY

An insured annuity strategy, commonly referred to as a "back-to-back" strategy, can be used inside a company. There are some benefits to holding an insured annuity inside a corporation, but there are also some drawbacks resulting from this structure.

The primary drawback is that the annuity held inside a corporation does not qualify for "prescribed annuity" treatment. A prescribed annuity levelizes the annual taxable portion of the annuity over its expected lifetime and sets the stage for some income and tax deferral. However, in order to qualify as a prescribed annuity, the annuitant (i.e., the payee under the annuity) must be an individual. Thus, the contract cannot qualify as a prescribed annuity where there is corporate ownership.

It should be noted that the loss of prescribed annuity treatment is not all bad. As the annual taxable portion of the annuity diminishes

over time, the after-tax amount increases. In essence, the non-prescribed annuity produces an "indexed" after-tax income.

The primary advantage of any insured annuity structure is the potential production of more after-tax cash flow than conventional investments and the eventual replacement of the capital used to purchase the annuity. A corporate-owned strategy has another potential advantage in the impact on the value of the shares upon the death of the shareholder.

Upon death, the deceased is deemed to have disposed of all capital assets for proceeds of disposition equal to their fair market value. (Where there is a rollover to a surviving spouse, such disposition will take place upon that spouse's death.) The deemed disposition will trigger the realization of any accrued capital gain inherent in the assets.

The insured annuity strategy may reduce the value of the shares held by the deceased for the purposes of calculating the capital gain at the time of that deemed disposition. The Income Tax Act contains a special rule that deems the value of a life insurance policy held by a company on the life of a deceased shareholder, for these purposes, to be its cash surrender value at the time of the death. This means that the fair market value of the shares upon the death of a shareholder will not reflect the imminent receipt of the life insurance proceeds, thus reducing any potential gain.

The valuation of the annuity component of the strategy for purposes of the deemed disposition at death is not necessarily as straightforward. One school of thought is that an annuity is an insurance policy and, therefore, subject to the deeming rule that sets the value at the cash surrender value of the policy (which for a life annuity is generally zero). The other approach is to try to determine a "fair market value" by asking what the market would pay for the life annuity. Keep in mind that this amount would decrease over time as the capital is depleted and the annuitant's age increases.

Also, where an annuity has no guarantee period (as is often the case in insured annuity arrangements) or where the guarantee period has expired, no annuity payments will be made after the individual's death. This makes for a stronger argument that the annuity has no value immediately before death.

The CRA rejected the first (cash surrender value) approach in a technical interpretation issued almost 10 years ago. However, there is no consensus that this interpretation is correct, and so the issue of the valuation of the annuity component remains unresolved.

Also remember that after the death of the shareholder, the corporation will receive the life insurance proceeds, get a credit to its capital dividend account and be able to distribute a tax-free capital dividend to the future shareholders of the company. It should also be kept in mind that the cash value of the policy is not used in producing active business income and, if it and other investment assets are sufficiently large in value, the shares may be ineligible for the lifetime capital gains exemption.

In summary, an insured annuity inside a corporation could increase the after-tax income from the assets invested and reduce the income tax liability of the estate, but each case must be assessed carefully on its own merits.

I/R 700.00

ATTENTION SNOWBIRDS

Winter is the time of year that many retired Canadians spend their time in warmer climates, most usually in the southern United States. While this change can be very enjoyable (as compared to the alternative of a long cold winter back home), these Canadians have to be wary lest they become subject to income tax in both countries. While there is relief from double taxation, the process and forms can be daunting.

The United States deems a Canadian who spends more than 182 days in the United States to be a U.S. resident for tax purposes. Similarly, a Canadian who passes a "substantial presence test" with respect to time spent in the United States may be treated as a U.S. resident.

A special formula is used to administer the substantial presence test. A Canadian who is resident in the United States 31 days in the current year and 183 days during the current and two preceding years would be caught by the substantial presence test. The "183 days component" is measured as all of the days in the current year, plus 1/3 of the days in the first prior year, plus 1/6 of the days in the second prior year.

Thus, the substantial presence test formula looks as follows:

Current year	all of the days	________	×	1	=	________
Prior year	1/3 of the days	________	×	1/3	=	________
Second prior year	1/6 of the days	________	×	1/6	=	________
				Total		________

If the total of this formula is more than 182 and the days in the current year are at least 31, then the Canadian has passed the substantial presence test.

While it may appear that a substantial presence would mean more than 1⁄2 of a year, the test will be met if the snowbird spent 122 days in the United States in each of the three years. This means that a Canadian could be considered a resident of the United States for taxation purposes if they regularly spend more than 121 days per year in the United States.

If the snowbird is considered a resident, then the U.S. has the right to tax the snowbird on his or her worldwide income. Such taxation in the United States would be in addition to Canada's right to tax the snowbird because he or she is resident in Canada.

To avoid this potential for double taxation (i.e., Canadian and American), the snowbird must prove that he or she spent less than 183 days in the United States in the current year and that he or she has a "tax home" in another country and has a closer connection to that other country. In order to make a valid claim under this exemption, the snowbird must file appropriate forms with the Internal Revenue Service in the United States. Such a form has to be filed by June 15 in respect of the prior year.

Visiting warmer climates is a reality for many Canadians and every one of them should keep careful records of the time spent in the United States as well as ensure that the appropriate forms are duly filed. While a Canadian will be considered a United States resident if he or she spends more than 182 days per year in the United States, they could be considered a United States resident if they regularly spend more than 121 days per year in the United States. While the Canadian has recourse against the substantial presence test, he or she must ensure that the appropriate compliance is followed.

I/R 7401.00

PRESCRIBED INTEREST RATE

The Income Tax Act defines a prescribed interest rate to be used for certain provisions of the Act. The prescribed rate is set each quarter, based on the yield on 90-day government T-bills issued during the prior three months. The current and recent rates are as follows:

2006	second quarter	4%
2006	first quarter	3%
2005	fourth quarter	5%
2005	third quarter	5%
2005	second quarter	5%
2005	first quarter	5%

The *prescribed rate* is used to calculate:

- the benefit on subsidized employee loans and mortgages
- the minimum rate to be used on loans between related parties

The *prescribed rate plus two per cent* is used to calculate:

- the interest given on tax refunds i.e., any amount owing by the government to a taxpayer

The *prescribed rate plus four per cent* is used to calculate the interest charged on:

- overdue tax liabilities
- insufficient tax instalments
- unremitted employee source deductions
- unpaid penalties i.e., any amount owing by a taxpayer to the government

The prescribed rate is important for many tax-planning strategies, so it is important to keep note of the figures and understand the application of the rates.

I/R 7401.00

GOVERNMENT PENSION PLANS: BENEFITS AND CONTRIBUTIONS FOR 2006

Contributions and benefits under government pension plans are adjusted periodically to reflect increases in the consumer price index or the average Canadian wage. The new amounts, commencing January 1, 2006, are shown in the table below. Each benefit is subject to income tax when received, with the exception of the Guaranteed Income Supplement and the Allowance. All benefits shown are paid monthly unless otherwise indicated and are the maximum amounts.

	CPP	QPP	OAS
CPP / QPP benefits (for new beneficiaries)			
Retirement pension (at age 65)	$844.58	$844.58	
Disability pension	$1,031.05	$1,031.02	
Disabled contributor's child benefit (each child)	*$200.47	*$63.65	
Survivor's*** pension			
• under age 55	**$471.85	**$714.30	
• age 55 to 64	$471.85	$716.31	
• age 65 or over	$506.75	$506.75	
Surviving child's benefit (each child)	*$200.47	*$63.65	
Death benefit (lump sum)	$2,500.00	$2,500.00	
Combined benefits			
• survivor's*** pension and disability (under age 65)	$1,031.05	n/a	
• survivor's*** pension and retirement (age 65 and over)	$844.58	$844.58	
Annual CPP/QPP contribution			
Self-employed (9.9%)	$3,821.40	$3,821.40	
Employee (matched by employer) (4.95%)	$1,910.70	$1,910.70	
Old Age Security (OAS)			
January to March 2006			$484.63
Guaranteed Income Supplement (GIS)			
January to March 2006			
• spouse/common-law partner receives OAS or Allowance			$389.67
• single person (or spouse/common-law partner receives neither OAS nor Allowance)			$593.97
Allowance			
January to March 2006			
• age 60 to 64, and spouse/common-law partner receives OAS and GIS			$874.30
• age 60 to 64, survivor's*** Allowance			$967.24

Notes:

* flat benefit amounts

** these amounts may vary depending on whether the survivor is under age 45, disabled, or with or without children

*** a survivor is the spouse or common-law partner of a deceased individual

I/R 3201.01 and I/R 3201.03

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