CLU™ INSTITUTE

COMMENT

Number 242 – MARCH / APRIL 2007

MORE THAN ONE TAX SPOUSE

The federal Income Tax Act (the Act) contains many provisions that allow tax deferral when spouses transfer ownership of property between each other. Generally speaking, a transaction between spouses can be completed on a rollover basis, where the transaction is recorded at the property's adjusted cost base and no taxable gain or loss will be realized.

The Canada Revenue Agency (CRA) was recently asked about the tax results of a transfer where a deceased individual had both a legally married spouse and a common-law spouse. The specific issue was whether the deceased taxpayer could bequeath his registered retirement income fund (RRIF) to his surviving common-law partner (as defined by the Act) under the rollover rules. The complication was that the deceased also had a legally married spouse from whom he was separated.

In the CRA's opinion, an individual can have two spouses for income tax purposes. The CRA stated that the deceased could bequeath his RRIF to his common-law spouse or his legally married spouse and either bequest would qualify for the spousal rollover rules. The CRA went on to say that either the common-law spouse or the legally married spouse could be named as the successor annuitant of the RRIF.

It should be noted that this technical interpretation does not necessarily extend to every provision of the Act. For example, to qualify for the spousal tax credit (available for common law or legal spouses), the spouses must be living together at year-end and cannot be separated because of a breakdown in their relationship.

From a planning perspective, the CRA's opinion might help where an individual has two spouses to provide for in his or her estate plan. For example, the separated legal spouse could be named as a beneficiary or successor annuitant of some or all of the individual's RRSPs or RRIFs, while the current common-law spouse could be provided for in other ways. Of course, the status of these relationships needs to be carefully monitored and estate plans and wills updated accordingly if the relationships between the individuals change.

I/R 2500.04, 5401.07, 7401.00

TRANSFER OF A CORPORATE-OWNED LIFE INSURANCE POLICY

In a recent technical interpretation, the Canada Revenue Agency ("CRA") provided its interpretation of the income tax consequences of a situation that many owner-managers of corporations face.

In the situation put before the CRA, an individual wanted to move a life insurance policy on his life from one company to another company where both companies were owned by the individual. This is a very common

type of transaction, because individuals often will need to reorganize their affairs over time. Similarly, the use of a life insurance policy can also evolve over time, leading to the need to be able to change the title and beneficiary on the policy.

The CRA opined on two issues with this transaction.

First, because the transaction was considered non-arm's-length, the CRA said that the provisions of subsection 148(7) would apply and the transfer would be deemed to take place at the cash surrender value of the life insurance contract. The first corporation would record proceeds of disposition equal to the cash surrender value of the policy and realize a taxable gain if the cash surrender value was greater than the adjusted cost basis of the policy. (It should be noted that a loss is not realized upon the disposition of a life insurance policy.) The second corporation would record an initial adjusted cost basis equal to the cash surrender value of the life insurance policy.

However, the CRA opinion went on to state that to the extent the first corporation was impoverished by the transfer of the policy, it would charge the individual shareholder with a taxable benefit equal to the reduction in value. In order to measure whether the first corporation was impoverished as a result of the transfer, the life insurance policy would have to be valued and the excess of the fair market value of the policy over the transfer price would appear to be considered the amount of the impoverishment.

The CRA gives some guidance with the respect to the valuation of a life insurance policy in Interpretation Bulletin IT-416R3 (*"Valuation of shares of a corporation receiving life insurance proceeds on death of a shareholder"* dated July 10, 1987). At paragraph 5, the CRA sets out the major factors to be considered: (1) the cash surrender value, if any, of the policy; (2) the life expectancy of the insured based on mortality tables; and (3) the state of the health of the life insured as it would be known to other persons.

It should be noted that subsection 148(7) deems the transfer between non-arm's-length parties to occur at the policy's cash surrender value, regardless of the actual transfer price. Even the sale of a life insurance policy at its full fair market value does not avoid the application of the rules in subsection 148(7); the policy is still deemed to be transferred at cash surrender value. At the same time, the impoverishment appears to be based on the amount paid for the transfer. There is therefore a mismatch in measuring values that can result in double taxation in some circumstances. This issue commonly arises in the case of the transfer of a policy from a corporation to a shareholder and this CRA opinion confirms that similar issues can arise on transfers between related corporations.

From a planning point of view, taxpayers and their advisors need to be aware that a life insurance policy requires special consideration when it is moved as part of a corporate reorganization or moved into a more "logical" location. At a minimum, advisors should always take the time to consider the fair market value of a life insurance policy and record these deliberations in the files for future reference.

I/R 5200.06

CORPORATE ATTRIBUTION

The Income Tax Act contains many attribution rules. Many individuals are aware of the rules that apply to loans or transfers of capital to other family members. However, the attribution rules that involve corporations can be confusing and can come into play many years after a restructuring because of the evolution of the business.

A common planning strategy is for parents to create a holding company above the family operating company. The operating company pays dividends up to the holding company equal to its after-tax income that is not required for operations, allowing the holding company to create an investment portfolio. This plan works well primarily because the income tax is imposed at the operating company level at a rate of approximately 20 per cent on income up to the small business limit, allowing 80 cents on the dollar to be invested. The investment portfolio created within the holding company will be larger than what could have been accumulated at a personal level if the after-tax income of the operating company had been paid out to the shareholder. It should be noted that personal income tax will have to be paid eventually when the funds are withdrawn from the holding company.

A common continuation of the plan is to have the parents freeze their value in the holding company and take back fixed-value preferred shares, while the children subscribe to common shares of the holding company. Under this structure, dividends can be "sprinkled" among the family members based on their needs and the objectives of the family. The strategy is to split income, lowering the overall taxation and creating more after-tax income for the family.

However, this seemingly straightforward planning extension can run afoul of an anti-avoidance measure in the Act. Once the holding company fails the definition of a small business corporation, the Act deems the parents to have received a certain minimum amount of income on the preferred shares of the holding company, no matter how much income they really took, how much income was allocated to the children or how much income the holding company earned. The parents would have to report an interest benefit equal to current prescribed rates times the value of their investment (loan or preferred shares) in excess of any interest and 5/4 of any dividends received on their investment in the holding company.

Note that this corporate attribution rule only applies once the holding company fails to meet the definition of a small business corporation. In general terms, a company is a small business corporation if all or substantially all of the fair market value of the assets are used in an active business carried on primarily in Canada. (For tax purposes, "all or substantially all" is generally interpreted to mean 90 per cent or more.) In the case of a holding company, it could eventually fail this definition if its investment portfolio grows large enough to throw the company offside. This benefit would begin in the year, for the whole year, that the corporation fails the above-noted definition.

An alternative planning strategy that should be considered would have the children subscribe to special shares of the operating company during the reorganization that introduced the holding company. The operating company can pay dividends to the children at the discretion of the parents based on their needs. This avoids the above-noted rule because the children would own shares of the operating company, which may be better able to meet the definition of a small business corporation over the long term.

The results of this alternative strategy are that the parents would own a holding company that would accumulate the after-tax income of the operating company. The holding company would also own the fixed value preferred shares of the operating company (plus maybe some common shares) and the children would own some, or all, of the common shares of the operating company. The parents would be able to control the operating company and thus be able to cause the operating company to pay dividends to the children based on their needs, or the parents could have the operating company clear its after-tax income up to the holding company.

Planning is an ongoing engagement, which means that situations and strategies have to be reviewed on an ongoing basis in order to ensure that something like corporate attribution rules do not come into play unexpectedly.

I/R 2101.07

PRESCRIBED INTEREST RATES

The federal Income Tax Act prescribes several interest rates to be applied in different situations. For example, taxpayers pay interest to the government on the late payment of income taxes, while the government pays interest to taxpayers on income tax refunds.

All of the interest rates referenced in the Income Tax Act use the same base amount: the prescribed interest rate. The prescribed interest rate is established each calendar quarter as the average rate (rounded to the next higher whole percentage) charged on 90-day Government of Canada Treasury Bills issued during the first month of the preceding quarter. Therefore, the prescribed rate is established at a time that is between two and five months before its application date.

	1st Q	2nd Q	3rd Q	4th Q
2007	5%	5%		
2006	3%	4%	4%	5%
2005	3%	3%	3%	3%

The deemed interest rate on employee and shareholder loans is the prescribed rate noted above plus two per cent. Similarly, if the federal government owes an amount to a taxpayer, the rate of interest paid by the government is the prescribed rate noted above plus two per cent.

The rate for overdue income tax payments, insufficient instalments, unremitted source deductions and unpaid penalties is the prescribed interest rate noted above plus four per cent.

When interest charges are applied by the government on items such as late income tax payments or shareholder loans, it is important to note any interest paid is not tax deductible. Alternatively, interest paid by the government to the taxpayer is considered taxable income.

Circumstances may dictate the application of an interest charge that had not been anticipated. However, careful planning can minimize unnecessary charges and ultimately save needless expense.

I/R 7401.00, 7300.04

Subscribe to CLU Comment today at **www.advocis.ca.**

Contributors to this issue of Comment:

James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:

CLU Institute
390 Queens Quay West, Suite 209,
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.cluinstitute.ca • info@cluinstitute.ca

This commentary is published by CLU Institute in consultation with an editorial board comprised of recognized authorities in the fields of law, life insurance and estate administration.

CLU Institute is the professional organization that administers and promotes the Chartered Life Underwriter of Canada designation.

The articles in CLU Comment are not intended to provide legal, accounting or other advice in individual circumstances. Seek professional assistance before acting upon information included in this publication.

CLU Comment may not be reproduced or distributed (by reprint, photocopy, electronic copy or any other means) without the prior written consent of CLU Institute. Any unauthorized use of the foregoing will be prosecuted to the full extent of the law.

Advocis™, CLU™ and APA™ are trademarks of The Financial Advisors Association of Canada.

Publication Agreement # 40069004

Copyright 2007 *ISSN 0382-7038* *All Rights Reserved*