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COMMENT

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CREDITOR PROTECTION FOR RRSPS

One of the chief advantages of naming a beneficiary of a life insurance policy is that the proceeds of the policy are excluded from the estate of the deceased. Through this exclusion, the proceeds are free from claim by any creditor of the estate. The proceeds are excluded from the estate because legal title irrevocably transfers upon the death and the proceeds become payable to the beneficiary at that time.

Registered retirement savings plans (RRSPs) and other "deposit instruments" issued by a life insurance company are technically considered to be life insurance policies. This means that if an individual holds an RRSP or an investment with a life insurance company and designates a beneficiary on these contracts, the death proceeds will typically be free from the creditors of the estate. The one exception to this rule relates to income taxes payable that arise because of the deemed realization of the RRSP at death. Where the estate does not have sufficient resources to meet its total income tax liability, the Canada Revenue Agency (CRA) has the ability to collect the tax on the RRSP from the beneficiary of the RRSP.

It has been commonly thought that the creditor protection associated with products held through a life insurance carrier does not extend to investments issued by banks, trust companies, credit unions, and other financial institutions. However, a recent court case in Ontario seems to impact this position and has attracted significant interest in the financial community.

On June 16, 2004, the Ontario Court of Appeal issued its decision in *Amherst Crane Rentals Limited v. Perring*, concluding that the beneficiary of a non-insurance RRSP did not have to release the funds to the creditors of the estate. The court laid out a reasoned approach, based on existing legislation, as to why a beneficiary designation on any RRSP plan puts the proceeds on death directly into the hands of the beneficiary and beyond the reach of the estate's creditors.

The issue was decided primarily on section 53 of Ontario's Succession Law Reform Act (SLRA), which provides as follows:

> *Where a participant in a plan has designated a person to receive a benefit under the plan on the death of the participant,*
>
> *(a) the person administering the plan is discharged on paying the benefit to the person designated under the latest designation made in accordance with the terms of the plan ...; and*
>
> *(b) the person designated may enforce payment of the benefit payable to him under the plan but the person administering the plan may set up any defence that he could have set up against the participant or his or her personal representative.*

The court reasoned that the legislation effectively places the funds in the hands of the beneficiary, thereby refuting the creditor's

claim that the funds passed through the estate first.

If this decision is not overturned on appeal to the Supreme Court, it may create uncertainty in other common-law jurisdictions in Canada. Section 53 of the Ontario SLRA is similar to the relevant legislation in Alberta, Manitoba, New Brunswick, Newfoundland and Labrador, and Nova Scotia. While the provincial courts in other jurisdictions are not bound by the Ontario decision, they may use the reasoning in the Amherst Crane decision to afford creditor protection in similar circumstances.

I/R 4351.00, 2121.00

GROUP CREDITOR INSURANCE

When an individual or company borrows money from a bank, the borrower is often asked to purchase group creditor insurance. The reason given for buying such insurance is to protect the borrower, yet the insurance also protects the bank. While the differences in these points of view may appear subtle, they should prompt the borrower to consider who really benefits from bank group creditor insurance.

The primary advantage of group creditor insurance is its low out-of-pocket cost. A secondary advantage is the limited amount of underwriting that takes place. However, there are significant advantages to the alternative strategy of putting a separate life insurance program in place.

The following discussion highlights important considerations when deciding between bank group creditor insurance and a personally owned or corporate-owned policy (or portfolio of policies).

1) Group creditor insurance only repays the outstanding balance on the bank loan rather than providing a fixed payout. This can significantly reduce the benefit that may ultimately be paid. If, for instance, the loan is a line of credit, the balance could be high during some periods of the year and low at other times. In addition, a loan is usually paid down over time, which means a diminishing amount of life insurance protection. Similar results would occur in respect of a mortgage where the principal balance is amortized over time.

   Alternatively, an insurance portfolio provides the face amount of coverage, so the necessary proceeds could pay off the loan balance while any excess proceeds could be used for other purposes.

   Consider the following example:

Insurance	Initial Coverage	Loan or Mortgage Balance At Time of Death	Payout
Group creditor coverage	$100,000	$20,000	• $20,000 to the lender • Zero to the borrower
Individual coverage			• $20,000 to the lender • $80,000 to the borrower

2) While group creditor insurance generally requires a limited amount of underwriting at issue, sometimes underwriting may be revisited at the time of the claim. Often, a group creditor plan that is tied to a mortgage is re-underwritten at each mortgage renewal, thereby increasing the risk that an individual may lose insurance coverage or be subject to rate increases.

   A properly constructed life insurance portfolio is much more secure (barring any issues such as fraud).

3) Group creditor insurance may be less tax effective, since a private corporation is not entitled to increase its capital dividend account where the proceeds arising upon the death of the insured are paid directly to the creditor. (The capital dividend account is advantageous since a tax-free distribution of any amounts in this account can be made to shareholders.) Group creditor insurance proceeds are not paid to the insured; instead, they are paid to the lender in repayment of the loan.

Alternatively, even though the proceeds from a corporate-owned life insurance policy may repay a bank loan, the corporation is still allowed to credit its capital dividend account for the amount of life insurance proceeds in excess of the adjusted cost basis of the policy.

4) The payment for group creditor protection is not a tax-deductible expense. For tax purposes, a deduction for a portion of collateral insurance premiums is only permitted where the owner of the policy is also the debtor. In the case of group creditor protection, the bank is the owner of the group insurance policy. An insurance portfolio, on the other hand, can be constructed so that a collateral insurance deduction may be available to the borrower.

5) Group creditor insurance is not portable. If the borrower repays the loan and takes out a subsequent loan at the same or a new institution, the coverage has to be underwritten again. Individual insurance, on the other hand, is owned by the individual and can be used to secure subsequent loans at the discretion of the owner.

   This issue can be extremely important if the health of the insured individual changes over time. New group creditor insurance may not be available at the lending institution, whereas current personally owned insurance can be kept in force for the benefit of the family.

6) Group creditor insurance is not convertible. If the needs of the borrower change, the individual cannot convert the group creditor insurance into a permanent plan and maintain the coverage. Individually owned term insurance may offer the right to convert, giving the borrower more future flexibility in financial planning.

Beware of bargains when buying a parachute. The same could be said of putting collateral insurance in place – what looks convenient and cheap could turn out to be much more costly.

I/R 3300.05

CAPITAL DIVIDENDS UNDER AN INSURED REDEMPTION STRATEGY

Most shareholder agreements have some form of a buy-sell arrangement. Often these arrangements provide for a redemption or repurchase of the shares from the estate of the deceased shareholder, and many arrangements fund that redemption using insurance proceeds. This insured redemption strategy is complex, involving trust (estate), personal, and corporate tax rules. Using the strategy, however, can result in significant tax savings on the shareholder's death. While the "stop-loss rules," which were introduced in 1995, reduced the tax advantages of this structure, strategies have evolved to work within the new tax rules.

The full redemption mechanism is too complex to be covered in this brief article. However, a key component of the strategy involves the generation of a deemed dividend in the hands of the estate. Part of this deemed dividend can be paid from the corporation's capital dividend account (CDA) and will thus be tax-free to the estate. For those situations that are not grandfathered from the stop-loss rules, the most tax-effective plan usually involves electing only a portion of the deemed dividend as a capital dividend. While this may appear simple, it can be difficult to implement in practice, since the *Income Tax Act* specifically states that the CDA election must be made in respect of the entire dividend.

One strategy to address this issue is to elect CDA treatment on the entire deemed dividend, and subsequently file an "excess" election to treat the excess amount as an ordinary taxable dividend. By definition, the excess amount is defined as the total deemed dividend in excess of the CDA balance. This means that if the target amount of the dividend is less than the actual balance in the CDA, no excess amount can exist. Therefore, before the elections are made, the balance in the CDA must be adjusted down to the level that will ensure that the CDA election and excess election function together properly.

The CDA balance could be reduced to the desired level by restructuring the share capital of the company so that a capital dividend could be paid on a unique share held by the surviving shareholder before the redemption is carried out. In this fashion, the value of the excess CDA credit can be used for the benefit of the surviving shareholder.

Alternatively, the CDA could be adjusted downward by increasing the paid-up capital of all of the shares. An increase in paid-up capital of the shares is treated as a dividend for which a capital dividend election can be made. In addition, an increase in paid-up capital of the shares will cause an equivalent increase in the adjusted cost base of the shares.

The results of increasing the paid-up capital are illustrated in the following example, where the paid-up capital of the shares has been increased from a nominal amount to $500,000:

Terminal Tax Return	
Deemed proceeds of disposition	1,000,000
Deceased's adjusted cost base	zero
Capital gain	1,000,000
Estate's Tax Return	
Proceeds of redemption	1,000,000
Less: Paid-up capital	500,000
Deemed dividend	500,000
Left as a taxable dividend	500,000
Proceeds of redemption	1,000,000
Less deemed dividend	500,000
Deemed proceeds of disposition	500,000
Estate's adjusted cost base	1,500,000
Capital loss	1,000,000
Reduction for stop-loss rules	zero
Capital loss carried back to the estate	1,000,000

This strategy allows the surviving shareholder to draw down on the high paid-up value associated with his or her own shares. To draw down the paid-up capital, a company can pay an amount to its shareholder as a reduction of paid-up capital, or a shareholder can receive payments that reduce the adjusted cost base and paid-up capital. To the extent that the shareholder's adjusted cost base is not reduced below zero, the surviving shareholder can receive the payment tax-free.

The redemption of the estate's shares continues to be a viable option in structuring a buy-sell agreement. However, the stop-loss rules now necessitate a careful analysis as to how best to allocate and utilize the tax benefits available with a CDA credit. In particular, attention must be paid to the amount of benefit provided to the deceased shareholder and the estate and to the surviving shareholder.

I/R 1450.03

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