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COMMENT

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REVERSIONARY TRUSTS

The attribution rules in the Income Tax Act ensure that income is not artificially shifted from one taxpayer to another as a means to access lower tax rates. In other words, attribution is a significant anti-avoidance measure to prevent income splitting.

Gifts and interest-free loans between spouses or between parents and their minor children are two of the more common circumstances that trigger attribution of income, thereby imposing undesirable tax results on income from property transferred between such non-arm's length parties. Attribution can apply to both direct and indirect transfers. For example, an indirect loan or gift can arise when a trust or holding company is interposed between these non-arm's-length parties.

Using an indirect transfer does not circumvent the attribution rules and can, in specific circumstances, create an additional penalty with fairly severe consequences. When a trust holds property in a reversionary situation, such as one where the property or substituted property may revert back to the transferor or may pass to other beneficiaries determined by the transferor (subsequent to settling the trust), two results occur:

- any income, taxable capital gains or allowable capital losses that arise from the contributed property are attributed back to the transferor; and
- the settled property, as well as any other property held by the trust, cannot be rolled out of the trust to any beneficiary other than the person from whom it was received or that person's spouse, former spouse or common-law partner. A distribution to any other person will take place at the property's fair market value.

The same results occur in circumstances where the transferor's consent is required in order for the trust to dispose of the property.

Consider the following example:

Dad settles a discretionary trust with a gold coin. The trust then borrows to buy common shares. The trust is established for the benefit of two minor children with Dad and Mom appointed as trustees who must act unanimously. The trust is to be distributed in 12 years when both children exceed age 25.

In this circumstance, income attribution rules would apply to any income earned on the gold coin since Dad transferred it to the trust and also controls who will receive it from the trust by virtue of the requirement that the trustees act unanimously. This income attribution will be minimal because a gold coin typically does not generate income. However, because the attribution rules apply to one trust property, the greater concern is that subsection 107(4.1) of the Income Tax Act would also apply. This means that when any trust property (i.e., either the gold coin or the shares) is distributed out of the trust, the transaction will be deemed to be a disposition at fair market value.

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In contrast, if the attribution rules had not applied to a trust property, then subsection 107(4.1) would not come into play and a distribution of property from the trust would generally occur on a tax-deferred rollover basis (under a deeming rule that allows a beneficiary to assume the distributed property with an adjusted cost base equal to the trust's adjusted cost base).

In this example, even though the common shares were purchased with borrowed money, a tax-deferred transfer or roll out would be denied because Dad could exercise discretion over which beneficiaries would receive the property he originally transferred to the trust.

While the direct financial consequences of attribution are often recognized, the tax impact of the rules on the eventual distribution of the property can be a surprising and costly consequence. To avoid the loss of the tax-free roll-out, the structure should ensure that the transferor's consent or discretion is not required in order to dispose of the property. For example, the transferor should not be the sole trustee or part of a majority or unanimous decision-making group. Additionally, the transferor should not have veto power.

It is important to note that even though circumstances may change and income attribution may cease, the penalty associated with the roll-out of property from the trust to a beneficiary will continue to apply. Thus, it is important to understand such future tax consequences when first establishing the trust and to be wary of achieving one objective at the expense of creating other issues.

I/R 1101.00, 8001.00

POLICY LOANS AND THE CAPITAL DIVIDEND ACCOUNT

Policy loans available as a contractual right under a life insurance contract have a unique taxation regime. Similarly, the capital dividend account that is available to a private corporation has its own unique tax rules.

The capital dividend account permits a private corporation to flow through to its shareholders certain non-taxable amounts received by the corporation. One such amount is the excess of any life insurance death benefit proceeds received by the corporation as the policy beneficiary, over the policy's adjusted cost basis to the corporation.

The relationship between policy loans and the capital dividend account was posed as a two-part question to the Canada Revenue Agency (“CRA”) at the 2004 Conference of the Fiscal and Financial Planning Association of Quebec. The CRA was asked about the amount eligible for credit to the capital dividend account when an outstanding policy loan reduces the proceeds payable to a beneficiary and what the timing of any impact to the policy's adjusted cost basis would be.

In the situation where a corporate-owned life insurance policy has a policy loan outstanding, the beneficiary is only entitled to receive the net amount of the death benefit after the insurance carrier has deducted an amount for repayment of the policy loan. The CRA viewed the policy loan repayment as a reduction to the beneficiary's entitlement and, therefore, did not consider the repaid loan amount as proceeds of the life insurance policy. As a result, the company would not be entitled to credit its capital dividend account for the portion of the death benefit that was used to repay a policy loan.

The second part of the question involved the timing of the calculation of the adjusted cost basis of the policy. When a policy loan is taken, the adjusted cost basis is reduced by the amount of the loan. A subsequent payment towards a policy loan would normally increase the adjusted cost basis of the policy. However, the CRA considered that, in this situation, the loan repayment occurred after the death of the life insured, not immediately before death. This means that the policy loan would not form part of the adjusted cost basis used to calculate the allowable addition to the CDA account.

The effect of the CRA's position with respect to this two-part question is that both the proceeds payable at death and the adjusted cost basis have been reduced by the same dollar amount. Thus, the amount eligible for the capital dividend account (i.e., the excess of the proceeds over the ACB) remains the same after a policy loan has been taken.

It should be noted that this issue is unique to the circumstances surrounding policy loans, so it does not arise in situations where the loan is taken from a lender other than the insurance carrier and the policy is assigned as collateral.

I/R 7401.043

2005 PRESCRIBED RATES FOR AUTOMOBILES

The federal Department of Finance annually reviews the prescribed rates that apply to the use of automobiles. These prescribed limits determine how much is deductible as a business expense as well as the amount taxable as an automobile benefit. The 2005 rates and some of the implications for owned and leased automobiles are described below.

Owned automobiles

For passenger vehicles used for business purposes, the capital cost on which capital cost allowance ("CCA") may be claimed will remain at $30,000 (plus GST and provincial sales tax on an amount up to the $30,000 limit) for vehicles acquired in 2005. This amount has not changed since 2000.

If the purchase of the passenger vehicle is financed, the allowable maximum monthly deduction for interest expense is $300.

It should be noted that the CCA rate is 30 per cent for automobiles. In the year of purchase, however, the rate is one-half of the normal amount, or 15 per cent. In the year of disposition of the automobile, a terminal loss or one-half of the normal amount is allowed, depending on the classification of the vehicle for CCA purposes (see the CRA guide T4002 Business and Professional Income).

Leased automobiles

For leased passenger vehicles, the maximum amount allowed as a monthly lease deduction remains at $800 (plus GST and provincial tax on amounts up to the $800 maximum) for the year 2005. Since lease payments are based on a wide variety of factors, there is also a further restriction that is based on the value of the vehicle. This additional limit is determined by prorating the actual lease payments by a ratio of the above $30,000 prescribed limit and 85 per cent of the greater of the manufacturer's list price ("MLP") or $35,294 (for the year 2005). This limit effectively ensures that the deductibility of automobile lease payments is limited where the MLP exceeds the prescribed limit of $30,000.

Travel allowance

The rate allowed as a tax-free reimbursement paid by an employer to an employee is being increased for 2005, to 45¢ per kilometre for the first 5,000 kilometres and 39¢ for each kilometre thereafter. It should be noted that these figures are higher for employees working in the Yukon, North West Territories and Nunavut. Amounts paid in excess of these prescribed amounts would be considered a taxable benefit to the employee and not deductible by the employer.

The income tax consequences of car ownership can form a significant component in many business decisions. Non-deductible expenses can increase a company's actual costs while taxable benefits can create significant creep in an employee's taxable income. While the income tax consequences should not drive business decisions, their impact needs to be well understood in order to appropriately evaluate the actual cost or benefit of the business use of automobiles.

I/R 1140.00

GOVERNMENT PENSION PLANS: BENEFITS AND CONTRIBUTIONS FOR 2005

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, 2005, 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)	$828.75	$828.75	
Disability pension	$1,010.23	$1,010.20	
Disabled contributor's child benefit (each child)	*$195.96	*$62.22	
Survivor's*** pension			
• under age 55	**$462.42	**$699.42	
• age 55 to 64	$462.42	$710.37	
• age 65 or over	$497.25	$497.25	
Surviving child's benefit (each child)	*$195.96	*$62.22	
Death benefit (lump sum)	$2,500.00	$2,500.00	
Combined benefits			
• survivor's*** pension and disability (under age 65)	$1,010.23	n/a	
• survivor's*** pension and retirement (age 65 and over)	$828.75	$828.75	
Annual CPP/QPP contribution			
Self-employed (9.9%)	$3,722.40	$3,722.40	
Employee (matched by employer) (4.95%)	$1,861.20	$1,861.20	
Old Age Security (OAS)			
January to March 2005			$471.76
Guaranteed Income Supplement (GIS)			
January to March 2005			
• spouse/common-law partner receives OAS or Allowance			$365.21
• single person (or spouse/common-law partner receives neither OAS nor Allowance)			$560.69
Allowance			
January to March 2005			
• age 60 to 64, and spouse/common-law partner receives OAS and GIS			$836.97
• age 60 to 64, survivor's*** Allowance			$924.04

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 3201.03

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