

# COMMENT

Number 249 – MAY / JUNE 2008

## Asset Protection

Most people think of asset protection in terms of keeping assets away from creditors and lawsuits. In today's modern society and the profession of financial planning, the definition of the term *asset protection* should be expanded to include plans, structures and strategies to ensure that your assets will be sufficient to complete your goals and objectives given the typical types of issues that will probably be encountered in life.

In this regard, asset protection can mean reviewing risks that can be insured and calculating whether to self-insure, partially insure or fully insure such risks.

The risks that can be insured for the assets themselves include fire, other damages and theft. Insurable risks that can deplete assets are death, disability, critical illness, the need for long-term care and liability. Each of these insurance products creates funds at the time of an event, which is generally the time cash or liquidity is needed for expenses.

Some people can easily afford to self-insure these risks because they have built up a significant amount of wealth. The decision for these people is, "What is the best use of capital – paying insurance premiums in advance of an event or paying the expense associated with an event at the time?"

Life insurance can be used to create cash upon the death of an individual or upon the death of the last surviving member of a couple. The issue is not isolated to whether the estate has the wealth to meet its need for cash, but rather what is the better use of capital. Cash or liquidity is needed in an estate to pay final expenses (such as funeral costs), pay off debt, fund a bequest, complete a charitable gift or fund an income tax liability triggered at death. The choice is whether

to use cash at the time of the death or shift some capital now into an insurance policy. The decision is a mix of risk management and investment management.

Insurance that provides lump-sum benefits following diagnosis of one of a number of specified "critical illnesses" creates cash upon the occurrence of one of the events listed in the contract. The occurrence of a critical illness can create extra expenses within the family, such as medical consultations, travel for medical assistance, travel expenses for family members, modifications to the home or vehicle, adjustment to an altered lifestyle, etc. While individuals with a good deal of wealth may be in a financial position to handle expenses and hidden costs related to a critical illness, the use of insurance can be a better use of capital and, from a psychological point of view, insurance money may be easier to spend than capital accumulated over a long term through a lot of hard work.

One of the biggest expenses a retired couple can face is the need to provide long-term care for themselves. If one spouse requires home care or needs to be placed in a facility, the expense will have to come out of their retirement assets. This could leave the other spouse with a much smaller pool of assets to provide for himself or herself.

Financial projections can be made to fully prepare for retirement. The basic risks of market volatility and inflation can be modelled to best show how prepared a couple is for retirement. These same models can show the financial impact of a premature death, critical illness or long-term care on the retirement assets in order to show why insurance may make sense, not from a risk point of view but from a capital point of view.

The bottom line is that financial planning, properly

done, should incorporate insurance diversification as well as investment diversification. The broad definition of asset protection is to ensure that your assets are

positioned to meet your needs and can mitigate many of the risks that we all face.

I/R 5601.00

## Principal Residence Trap

The principal residence exemption is an important part of the Income Tax Act because it allows the growth in the value of the family home to be sheltered from taxation. The principal residence exemption is claimed against the capital gain realized on the sale of the family home (and up to a half-hectare – roughly an acre and a quarter – of the land on which it stands) and therefore avoids the associated income tax liability.

However, the exemption is not without its traps. Consider the following situation.

Mom and Dad wanted their family cottage to stay in the family and sought the appropriate advice to ensure the cottage could be shared by their children. After reviewing the options available to them, they settled on the use of a discretionary family trust to hold the cottage for their five children. They transferred the cottage to the newly created trust and used their own principal residence exemption to avoid the tax on the accrued capital gain on the cottage at the time of the transfer.

For many years, the children enjoyed the cottage and were very thankful to their parents for having thought so far ahead. However, after a number of years, the children mutually agreed to sell the cottage. The decision to sell was based on many things, including the passing of time since mom's and dad's death, and the fact that only one child lived close enough to take care of the cottage. In addition, the next generation was less interested in the cottage and the 21-year deemed disposition of the trust assets for income tax purposes was approaching. (The 21-year deemed disposition would mean that any capital gain on the cottage would be triggered at that anniversary.)

When the trust sold the cottage, it allocated the resulting capital gain to the youngest child because he did not own a home. This allowed the trust to claim the principal residence exemption, avoiding the associated tax on the realized capital gain. The cash of the trust was then distributed to the children who each created their own financial plans with it.

The trap was sprung a few years later when the oldest child sold her home in the city. She and her husband had been very fortunate to realize a significant appreciation in the value of their home and wanted to trade up to a bigger property. Imagine their surprise when they learned that a designation by a trust is a designation for each beneficiary of the trust. Since the trust had in effect already designated the cottage as the daughter's principal residence (via the discretionary trust), she and her husband could not designate their city home as their principal residence for the same years.

Planning with respect to the principal residence exemption should not be undertaken lightly. Before a property is designated as a principal residence, other property ownership should be reviewed to ensure that the use of the exemption avoids the greatest amount of tax and no traps are created for future transactions.

For example, where a couple owns a city residence and a cottage, a full record of the cost of all capital improvements is required for both properties. Assembling this documentation as early as possible will be much appreciated by anyone making the calculations perhaps decades from now.

I/R 7401.00; 8001.00

## Office In The Home

An office in the home is important for many people because of the convenience and economics of the situation. To the extent an office is operated out of an individual's home, a certain amount of the house-related expenses may be tax deductible against the income generated.

There are three types of individuals who can claim expenses related to operating an office in the home: salaried employees, employees on commission and self-employed individuals. This distinction is important because each subsequent group is entitled to a longer list of deductible items.

In any case, the amount of deductible expenses will be limited to the amount of income earned by the activity operated out of the home office. Any eligible expenses in excess of income from this source that cannot be deducted in the year can be carried forward and deducted in a subsequent year.

The first criterion, applicable to all three groups, is that the place in the home is where the individual does the principal amount (i.e., more than 50 per cent) of his or her work, or the place is used exclusively (i.e., 100 per cent) on a regular and continuous basis to meet with customers or other persons in the course of the work. The regular and continuous use of the space was challenged by a physician who maintained a medical office as well as an office in his home. He was able to demonstrate that he "met" with his patients by phone and regularly took phone calls in his home office.

The second issue to be addressed is the reasonable allocation of business versus personal expenses. Reasonableness is usually established by calculating the ratio of personal versus business proportion of the home. Generally square footage is used to calculate the ratio. If the home office is used for both business and personal purposes, the expenses need to be further prorated. For example, where the home office represents 20 per cent of the floor space of the home and it is used 80 per cent of the time for business use, then the overall business use proportion is 16 per cent. The ratio is then applied to the total expenses of operating the home to arrive at the deductible portion.

An *employee* can deduct a portion of his or her electricity, heating, rent (if a rental property) and maintenance but not property taxes, home insurance, mortgage interest or capital cost allowance. In the case of maintenance costs, it may not be appropriate to use a percentage of these costs but rather a review should be done to determine whether the maintenance applied to the work area in the

home or client access to the home.

A *commissioned employee* can deduct a few more expenses than a non-commissioned employee. In addition to the expenses allowed to a salaried employee, he or she can also deduct a portion of the property taxes and insurance related to the home office space. However, mortgage interest and capital cost allowance are not deductible.

Note that in order for a salaried or commissioned employee to claim expenses related to a work space in the home, the individual must be required by his or her employment agreement to incur those expenses and the employer must certify that requirement by the completion of Form T2200 – *Declaration of Conditions of Employment*.

A *self-employed individual* can deduct an even greater number of expenses. He or she can deduct a portion of maintenance costs such as heating, home insurance, electricity and cleaning materials. He or she can also deduct a part of the property taxes, mortgage interest and capital cost allowance. It should be noted that if capital cost allowance is claimed, the taxpayer could be subject to tax on the recapture of the capital allowance claimed if the home is subsequently sold for more than its cost base and that the use of the principal residence exemption will be denied on this portion of the residence, exposing this portion to tax on any resulting capital gain.

Claiming appropriate tax deductions is an important part of tax planning and helping individuals maximize their financial positions. Self-employed individuals have until June 15<sup>th</sup> to file their tax return from the prior year, but only until April 30<sup>th</sup> to pay any tax liability in order to avoid interest and penalties.

I/R 7401.00

## Truth Is Stranger Than Fiction

There is a tax credit available for those individuals who support another in their home, often called the “equivalent to married” tax credit. It is an important credit because it can reduce the tax otherwise payable by the individual, thereby leaving more money to support the household.

In order to be eligible:

- the individual and the other person must not be married or living in a common-law partnership. For individuals who are married, they cannot be living together with their spouse nor be supported by the spouse; and
- the individual must maintain a self-contained home either alone or jointly with others and support another person who is:
  - o resident in Canada, unless that other person is a child of the individual,
  - o wholly dependent on the individual for support,
  - o related to the individual, and
  - o under the age of 18, unless it is the individual’s parent or grandparent or dependent on the individual by reason of mental or physical infirmity.

The 2008 non-refundable tax credit is equal to \$9,600 less the net income of the other person times the lowest marginal tax bracket in the province of residence.

This tax credit generates a tremendous number of reassessments against individuals claiming the credit when they do not meet all of the conditions. And, beyond appeals at the tax assessment level, some individuals turn to the courts for satisfaction.

While many cases are decided against the taxpayer, there are always a few cases where the judge decides in favour of the taxpayer.

The facts of one such case were as follows:

- the taxpayer was separated from his former spouse; and
- the taxpayer resided with his son in a self-contained one-bedroom apartment in the former matrimonial home, while his former spouse occupied the rest of the home. The taxpayer’s son slept in another room within the home (i.e., that was outside of the self-contained apartment).

In his decision, the judge noted that there was no requirement that the dependent person sleep in the self-contained domestic dwelling with the taxpayer, only that the taxpayer sleep in that dwelling and that the dependent person must “live with” the taxpayer.

Tax credits are an important component of the system and it is important to know the rules, and how they are interpreted under current law, in order to optimize one’s tax situation.

I/R 7401.00

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### 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](http://www.cluinstitute.ca) • [info@cluinstitute.ca](mailto:info@cluinstitute.ca)

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Publication Agreement # 40069004