
TRANSFERRING A POLICY

Time has the ability to change almost everything and estate plans are no exception. While an estate plan may carefully structure the ownership and beneficiary designations of a life insurance policy, shifting circumstances may necessitate later changes to the plan.

While a beneficiary designation can be changed without any income tax implications, changing the ownership of an insurance policy is considered a disposition of the contract. Such a disposition could result in an income inclusion for the policyholder if the proceeds of the disposition (often the policy's cash surrender value) are greater than the adjusted cost basis of the contract.

One exception to the above is the rule that provides for a rollover where a policy is transferred between spouses. The transferor spouse will be deemed to have proceeds of the disposition equal to the policy's adjusted cost basis (ACB) and the recipient's ACB will be the same amount. This rule is very similar to others in the Income Tax Act that allow for the tax-deferred rollover of capital property between spouses.

Another exception to the rule can occur when a policyholder transfers title for a policy on the life of a child, for no consideration, to a child of the policyholder. Often, this happens when a parent buys a policy on the life of his or her child and later transfers title on the policy to that child, typically when the child is at least 18 years of age. The transferee child, however, does not have to be the child whose

life is insured. Note also that the definition of "child" includes children, grandchildren and great-grandchildren and their spouses or common-law partners.

This rollover rule for children provides some interesting planning opportunities.

- 1) A grandparent could buy a policy on the life of his or her child and transfer title to a grandchild. This could set the stage for a form of educational funding, in that the grandchild would be taxable on withdrawals from the policy (assuming the child was at least 18, thereby avoiding the attribution rules). When the grandchild is finished university, title could be transferred back to the grandparent or to a parent (although the rollover would not be available on this transfer).
- 2) A parent could buy a policy on the life of his or her new daughter- or son-in-law and later transfer title to the son or daughter. This allows the parent to help provide financial protection to the child and later give control to that child.

Note that for the rollover to apply, the Canada Revenue Agency (CRA) has indicated that the child must be the only life insured under the policy. The rollover will not apply to a multi-life contract or a joint life contract.

However in a technical interpretation, the CRA was asked what the result would be if the parent bought a joint-last-to-die contract on the parent's and child's lives and upon the death of the parent the policy was transferred

to the child. The CRA's response was that at the time of the transfer, the parent was deceased and therefore there was only one life insured under the policy – the child's life. Thus the rollover would be permitted.

Sometimes, estate plans need to be updated and life insurance policies may need to be transferred. At such times, it is important to understand that special rules can apply to such transfers.

I/R 4400.00

PENDING CHANGES TO DIVIDENDS

On November 23, 2005, the Department of Finance announced a proposal to reduce the federal income tax rates on certain dividends in an effort to reduce the tax advantage enjoyed by income trusts.

Income trusts are attractive from an income tax perspective since the business income earned by the trust is taxed at the unitholder level rather than at the corporate level and then again at the shareholder level. This is especially important for tax-exempt investors such as pension funds and RRSPs since avoiding that first level of corporate taxes can increase the rate of return on these types of investments.

By lowering income tax rates on certain dividends, the Department of Finance hopes to level the playing field – the proposal increases the attractiveness of dividends and

the dividend distribution. The chart below illustrates the impact of the change.

The proposed change is intended to reduce the total tax burden to an amount that is closer to the amount of tax the shareholder/investor would have paid by earning the income directly. Note, however, that the actual effect of this change will be highly dependent on the province of residence, since the provinces have different tax rates. However, since provinces do not have to change their dividend tax credit rates when the federal rate is changed, income trusts could continue to provide a significant advantage depending upon whether a particular province follows the federal proposals.

The Department of Finance release indicates that the dividends eligible for the higher gross-up and tax credit will be those

		Large Corporations		
		Current	Proposed	Income Trusts
Business operation:				
A	Income	1,000	1,000	1,000
B	Corporate tax	320	320	nil
C	Distributable cash	680	680	1,000
Individual investor:				
D	Taxable income reported (i.e., after dividend gross-up)	850	986	1,000
E	Federal tax at 29%	247	286	290
F	Provincial tax (assume 15%)	128	148	150
G	Federal dividend tax credit	113	187	nil
H	Provincial dividend tax credit (assumed to be 60% of federal credit)	68	112	nil
I	Net taxes paid by shareholder/investor	194	135	440
J	Total taxes paid	514	455	440

therefore reduces the attractiveness of income trusts as an alternative to corporations.

The proposal involves grossing up certain dividends by 45 per cent (rather than the current 25 per cent) and changing the dividend tax credit to 19 per cent of the grossed-up dividend (rather than 13.33 per cent currently). This change will reduce the element of double taxation that is present when corporations pay tax at the corporate level and then the shareholder pays tax on

amounts paid after 2005 by public corporations that are resident in Canada and subject to the general corporate income tax rate.

Certain dividends from a Canadian-controlled private corporation (CCPC) will also qualify. To the extent a CCPC's active business income (i.e., not investment income) is subject to the general corporate income tax rate (i.e., income above the small business deduction limit), then the new rules apply to dividends paid from that pool of after-tax

income. Special rules will apply to ensure that dividends that pass through a corporation will retain their character as dividends eligible for the enhanced gross-up and credit or ordinary dividends subject to the current rules.

The new rules appear to create the need for special record keeping for CCPCs, so that retained earnings are segmented for income taxed post-2005 at the general corporate income tax rate and all other income.

I/R 2101.07

PREPARING YOUR TAX RETURN

Once again it's the time of the year when we go digging through boxes and files in search of receipts and forms for the annual filing of our income tax returns. Even after everything has been gathered, the task of completing the various forms that are required remains.

The following is a list of the more common mistakes, exceptions and issues that the Canada Revenue Agency (CRA) has identified as problems that slow their review process.

Adding – Every year, adding mistakes make it to the top of the CRA's list. An adding mistake will be corrected by the CRA, but it could lead to late charges, penalties and interest if the payment that accompanies the tax return is less than the actual liability.

Self-employment income – The Canadian tax system is a self-reporting system. However, the government retains the right to audit such reporting. Self-employed taxpayers must report all of their revenue and are entitled to claim reasonable expenses incurred to earn such revenue. Under-reporting of income or claiming unreasonable expenses will cause delays or subsequent reassessments.

Carrying charges – Carrying charges are deductible to the extent they are incurred to earn income from business or property. If interest expense is being deducted from income, the taxpayer will have to ensure that none of the borrowed money was used for personal reasons. It may make sense for the taxpayer to have two lines of credit, one for investment purposes and another for personal purposes.

Foreign tax credits – Foreign taxes can be deducted or used to claim a tax credit depending on the circumstances. The taxpayer is required to support the total amount of foreign income as well as the amount of foreign taxes paid in respect of such income. It is important to segment and track foreign

income by country, as foreign tax credits are calculated on a country-by-country basis.

Province of residence – You have to pay provincial tax based on your residency as of December 31st. No matter how long a taxpayer spends in one province during the year, it is the province of residence as at December 31st that dictates which province has the right to tax that individual.

Charitable donations – Typically, it has been CRA's administrative practice to allow one spouse to claim the charitable donation receipts received by both spouses. This can be advantageous because the first \$200 of donations creates a tax credit at the lowest tax bracket and donations over \$200 create a tax credit at the highest tax bracket.

Employment expenses – Certain employment expenses are deductible from employment income, but only if certain conditions are met. Generally, if the employee is required to maintain an office within his or her home, then a portion of the related expenses is deductible.

Child care expenses – Child care expenses are deductible by the lower-income spouse if they are incurred in order to earn income, but only up to certain maximums based on the age of the child. While the actual receipts do not have to be submitted with the income tax return, the taxpayer should retain them in case of a review.

Tuition and education expenses – Tuition payments and education expenses create a tax credit for the student, no matter who pays the actual tuition. The student can transfer any unused credits (within certain limits) to his or her parent.

It is important to be as thorough as possible when completing your tax return. Otherwise, you may forfeit tax savings or become exposed to tax penalties and interest by omitting or misfiling information.

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EXECUTOR'S CHECKLIST

The role of the executor is often seen as that of someone in complete control with unlimited decision-making powers. In reality, the executor's role is more methodical and typically involves a heavy emphasis on record keeping, with very little decision-making authority because the will lists all of the testator's intentions. The executor simply gathers the estate assets and carries out the wishes as documented by the testator in his or her will. It is important to know that the average

estate can take as long as a full year, and maybe even two years, to completely settle.

The following list identifies some of the important tasks of the executor.

Every estate is different and the role of the executor is to follow the basic procedures and ensure that the testator's wishes are observed and the beneficiaries' interests are protected. The role of the executor is not glamorous, but rather one of detailed processes, record keeping and reporting.

Gather	<ul style="list-style-type: none"> Locate the will Locate all assets and arrange for appraisals <ul style="list-style-type: none"> review the deceased's personal papers for clues real estate, bank and investment accounts Collect any debts owing Locate any life insurance policies on the deceased Locate any life insurance policies with premium waiver riders 	<ul style="list-style-type: none"> Locate any critical illness policies with a refund on death rider Identify all liabilities Locate guarantees, if any Locate any credit card records to look for accounts that may offer insurance on the outstanding balance Identify all outstanding debts and supporting documentation
Retain	<ul style="list-style-type: none"> A lawyer 	<ul style="list-style-type: none"> A professional trustee, if warranted
Notify	<ul style="list-style-type: none"> Notify beneficiaries identified in the will 	<ul style="list-style-type: none"> Arrange for publication of notice to creditors
Check	<ul style="list-style-type: none"> Check with deceased's employer regarding: <ul style="list-style-type: none"> unpaid salary unpaid vacation and/or sick leave 	<ul style="list-style-type: none"> – pension options – other employee benefits Check for a safety deposit box or a storage locker
Inform	<ul style="list-style-type: none"> Send notices of the person's death and executor contact information to: <ul style="list-style-type: none"> government agencies from which deceased was receiving benefits banks credit institutions 	<ul style="list-style-type: none"> – utility services – post office (change of address for mail, if appropriate) – previous employers if there are current/potential pension benefits that may be impacted¹
Do	<ul style="list-style-type: none"> Prepare a detailed listing of all assets and liabilities Arrange for storage and insurance for assets Apply to the court for letters probate Pay valid debt and valid claims against the estate Pay funeral expenses Pay legal and executor fees 	<ul style="list-style-type: none"> File for Canada Pension Plan benefits, if any File for life insurance and other benefits owing File the terminal income tax return plus any other outstanding tax returns Request clearance certificate once all income tax returns are filed and all outstanding income tax amounts are paid
Finally	<ul style="list-style-type: none"> Distribute assets to the named beneficiaries File papers to finalize the estate 	<ul style="list-style-type: none"> Keep a copy of all records

¹ Providing executor contact information to pension administrator will help to ensure that beneficiaries are included should there be any future benefits for which the deceased may become eligible (e.g., plan wind-up at a future date).

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