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COMMENT

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Corporate-Owned Life Insurance

At a recent Canadian Tax Foundation meeting, the Canada Revenue Agency (CRA) changed its opinion about the tax implications of a common corporate-owned life insurance scenario.

The scenario involves an individual who owns a holding company, which in turn owns an operating company. The operating company owns a life insurance policy on the life of the individual and names its holding company as the beneficiary of the life insurance policy. The CRA indicated at the Tax Foundation meeting that the shareholder taxable benefit rules would apply in this situation, which is a change to its previous position.

The application of a shareholder taxable benefit sets up a double tax situation. The insurance premiums are not deductible by the operating company in determining its taxable income. At the same time, the holding company would be required to include an amount related to the insurance premiums as a shareholder taxable benefit in determining its taxable income.

The CRA indicated that this change in position would be phased in prospectively. For new policies acquired after 2009, the new assessing policy will apply immediately from January 1, 2010, onward. For policies issued before 2010, the new position will apply beginning January 1, 2011.

In addition to explaining its change in position on the shareholder benefit, the CRA also reiterated that it may apply the general anti-avoidance rules (GAAR) if the structure is deemed to exist for the purpose of maximizing the credit to the capital dividend account.

This change in position by the CRA means that taxpayers and their professional advisors should immediately review all corporate-owned life insurance structures to ensure that they are not surprised by a CRA assessment.

I/R 5200.01

Trusts: Beware Of Audit Potential

The Canada Revenue Agency (CRA) recently announced its intention to undertake a special project to audit domestic inter vivos trusts. Apparently, the CRA is concerned that some trusts have not been properly constituted and some are not being managed according to the necessary trust and income tax laws. To the extent a trust is outside the rules, the CRA may be able to issue a reassessment, which may result in income tax liabilities, penalties and interest.

The question of whether a trust is properly constituted dates back to the 1840 landmark British case, Knight v. Knight. To properly constitute a trust, there must be three certainties: certainty of intent, certainty of property and certainty of objects.

Intent: There must be a clear intention by the settlor to create a trust to hold property on the behalf of the beneficiary(ies).

Property: The property or subject matter of the trust must be clearly identified. For example, a general instruction to “settle the majority of my estate” would not satisfy the certainty of property criterion.

Objects: The beneficiary(ies) of the trust must be clearly identified or at least ascertainable. For example, a testator who leaves his residence in a trust

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for his "neighbours" would not meet this condition because the beneficiaries are not clearly identifiable. Who are the neighbours? Next door, down the street or where specifically? Beneficiaries can include individuals not yet born as long as the class of beneficiaries is clearly identified. Alternatively, the objects of a trust could be a charitable purpose rather than specific beneficiaries.

In terms of trust administration, there are numerous issues to consider in order to meet the requirements of the law.

Many trusts are settled with a gold coin or silver wafer because these items do not generate income that could create income tax consequences for the trust, settlor or beneficiaries. Income from the property settled on the trust may cause the application of attribution rules with income allocated to the beneficiaries being attributed to the settlor. The property settled on the trust must be available or traceable to substituted property. This could be a problem if the gold coin or silver wafer is misplaced or the trust was settled with currency that was misplaced.

Many trusts allow the trustees to pay amounts directly to third parties on account of the beneficiaries' expenses. However, proper record and bookkeeping by the trustees is a must in order to avoid later confusion and unanticipated tax consequences. The trustees must be able to prove that trust funds were spent on qualified beneficiary expenses – otherwise the amounts could be considered a misappropriation of trust funds and the beneficiaries could claim that the trust still owes them for income allocated and not distributed.

For income tax purposes, a trust is generally deemed to have disposed of its capital property on its 21st anniversary and every 21 years thereafter. This could result in a tax liability even though the capital property is retained. The CRA intends to ensure that every trust complies with this provision where it is applicable.

Many times, trust structures are established such that:

- the property is held on the condition that it or substituted property may revert to the person from whom the property was received;
- the property may pass to persons determined by the transferor at a time subsequent to the creation of the trust; or
- the property may not be disposed of during the lifetime of the transferor without his or her consent or discretion.

If the trust contains any such provision, then it is considered a "reversionary" trust and any income, loss, capital gain or capital loss will be attributed to the transferor. In addition, this can affect the rollout of property from the trust. Also note that the funds held in trust for a minor cannot be gifted back to the settlor without creating tax issues.

Many trusts are structured to hold shares of a private corporation so that income splitting can be accomplished within a family. Care has to be exercised when the company fails to meet the definition of a small business corporation (SBC). An SBC is defined to mean a Canadian-controlled private corporation where all, or substantially all, of the fair market value of the assets can be attributed to an active business carried on primarily in Canada. If the company fails to meet the definition of an SBC, the individual who transferred funds to the trust may be deemed to have received an interest benefit.

Trusts are a common vehicle in many estate plans and corporate scenarios. In anticipation of the CRA's audit initiative, taxpayers and their professional advisors should take the time to review arrangements that are in place to ensure compliance. Such a review may uncover issues to be addressed or opportunities to be explored.

I/R 8001.00

Transferring a Life Insurance Policy

When a life insurance policy is transferred, the Income Tax Act contains a significant number of rules that dictate the income tax consequences. A life insurance policy is not capital property; therefore, it is not eligible for special rollover treatment except in respect of the following scenarios.

There is a tax-deferred rollover of an insurance policy when ownership is transferred between Canadian-resident spouses. It is the ownership of the policy that matters, not whose life is insured. For example, if John owns a life insurance policy on the life of his brother Adam, John can transfer this policy to his spouse, Pat, on a rollover basis. This rollover is automatic; however, the taxpayer

can elect out. Note that there would not be rollover treatment available if John were to transfer the policy to Adam's spouse.

There is a tax-deferred rollover of a life insurance policy owned by a parent or grandparent on the life of a child when it is transferred to a child. This facilitates the opportunity for parents or grandparents to acquire life insurance on their child or grandchild, and later in life transfer the policy to the life insured or another child or grandchild. It should be noted that in CRA's opinion, the child has to be the only life insured under the policy (i.e., the policy cannot insure more than the life of the child on a multi or joint basis).

When a policy is transferred between other non-arm's-length individuals, there is a deeming provision that sets the proceeds of disposition at the cash surrender value of the policy irrespective of the amount, if any, paid by the transferee. Since the policy is not capital property, any policy gain is fully subject to income tax. This cash surrender value will also represent the adjusted cost basis of the policy to the person who acquires it.

Finally, a life insurance policy receives rollover treatment during the wind-up of a corporation where the rollover rules apply to the assets of the corporation or upon the amalgamation of two or more corporations. The rules work to keep the adjusted cost basis of the insurance contract constant as it moves to the new corporation.

Insurance policies are acquired to address specific needs and objectives. Over time things change and it may become necessary to transfer ownership of the insurance policy to better meet the updated facts of the situation or the objectives of the individual policyholder. Rollover treatment and deemed treatment can save the policyholder from excess tax liability and planning should consider every opportunity. Remember, however, that the rules can be complex and professional advice should be obtained when a life insurance policy is to be transferred.

I/R 7401.04

Tax-Deductible Expenses

The Income Tax Act provides for the deduction of expenses against income when calculating taxable income. However, the type of expenses that are deductible will depend on the circumstances of the taxpayer and the type of income being earned.

The Income Tax Act essentially recognizes three broad types of individual who can deduct certain expenses from their income:

1) an employee;

2) a commissioned employee; and

3) a self-employed individual.

The employee is the most restricted in the type of expenses that are deductible, while the self-employed person faces the fewest such restrictions. The types of expenses that could be deductible for each class of individual taxpayer are as follows:

	Employee	Commissioned Employee	Self-Employed
A portion of car expenses, lease payments, interest on car loan, automobile capital cost allowance (CCA), gas and operating expenses	✔	✔	✔
Business travel expenses	✔	✔	✔
Office rent and office supplies	✔	✔	✔
Business long distance and cellphone air time	✔	✔	✔
Salary for secretary/assistant		✔	✔
Business portion of lease payments for office equipment and cellphones		✔	✔
Meal and entertainment expenses		✔	✔
Association membership dues		✔	✔
Advertising and promotion expenses		✔	✔
Expenses to attend two conventions per year			✔
CCA on business assets			✔

An employee must have his or her employer complete form T2200, which sets out the individual's conditions of employment. The employee must be required to carry on his or her duties away from the employer's offices and be required to pay his or her own business expenses.

A commissioned employee is allowed to deduct the expenses noted but only to the extent of commission income reported.

Expenses with respect to an office in the home may be deductible. The work space must be the individual's principal place of business and must be used on a regular and continuous basis for meeting clients. From a calculation point of view, the total home expenses are calculated and a reasonable portion is attributed to the business use of the home. The reasonable portion could be determined by considering the square footage of the workspace and comparing it to the square footage of the home.

The type of home expenses that are deductible is also based on similar differentiation between employees, commissioned employees and self-employed individuals. The following is a summary of deductible expenses.

	Employee	Commissioned Employee	Self-Employed
Utilities for home	✔	✔	✔
Rent for the home	✔	✔	✔
Property taxes		✔	✔
Insurance for the home		✔	✔
Interest on home mortgage			✔
Capital cost allowance on home			✔

Note, however, that the entire residence can only continue to qualify as a principal residence if no capital cost allowance is claimed on the home.

The deduction of expenses will lower an individual's income tax liability. The taxes saved will in turn lower the costs related to earning income.

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