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COMMENT

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Disposition Of A Life Insurance Policy

The definition of the disposition of a life insurance policy or an interest in a life insurance policy for tax purposes does not necessarily follow the common sense meaning of the term. The Income Tax Act contains its own definition of what does and does not constitute the disposition of an interest in a life insurance policy, and what is not a disposition.

The disposition of an interest in a life insurance policy includes a:

a) surrender;

b) policy loan;

c) transfer of ownership;

d) maturity; and,

e) disposition by operation of law.

The disposition of an interest in a life insurance policy does not include:

a) a collateral assignment where there is no change in the ownership of the policy;

b) a lapse if the policy is reinstated within 60 days of the next calendar year-end;

c) payment of a disability benefit or accidental death benefit;

d) an annuity payment;

e) a payment as a consequence of the death of the person insured; and,

f) conversion of the policy to an annuity if the person insured is totally and permanently disabled.

Generally speaking, the income inclusion resulting from a disposition will be the proceeds of the disposition in excess of the taxpayer's adjusted cost basis ("ACB") of that interest in the policy. Since a life insurance policy is not capital property, the more common term "adjusted cost base" is not technically applicable, although the acronym is the same. Also remember that the gain on the disposition of a life insurance policy is not a capital gain but is fully taxable on income account. The proceeds of the disposition are generally equal to the amount the policyholder receives upon the disposition, and it should be noted that the taxable income, the taxable policy gain, is not a capital gain, even if the income credited to the policy's fund is calculated by reference to equity investments or indices.

There are a number of exceptions to the general rule that proceeds of the disposition equal the amount received by the policyholder. A tax-deferred rollover of any life insurance policy is allowed between spouses, and for lifetime policy transfers from a parent to a child where a child is the life insured. There is a separate definition of deemed proceeds of the disposition for transfers between other non-arm's-length parties.

In situations involving the partial surrender of a policy, the ACB of the policy must be prorated. Technically, the ratio used to prorate the ACB is the proceeds of the disposition divided by the accumulating fund (as tracked by the insurer) of the policy. Often, the accumulating fund will be equal to the cash surrender value of the policy. For example, a policyholder owns a policy with a $50,000 accumulating fund/cash surrender value, and requests a payment of $10,000 out of this value. The ACB allocated to the withdrawal would be equal to 20 per cent of the total policy ACB (i.e., $10,000/$50,000).

In the situation of a policy loan, no such proration is required, which means the policyholder could 'borrow' out his or her entire ACB before any taxable policy gain would arise. Let us assume, for example, the total cash surrender value is $80,000, the total ACB is $40,000, and the policyholder requests a $50,000 policy loan. In such a situation, $10,000 of income would be reported. This is the excess of the policy loan proceeds over the full ACB of the policy.

In situations involving a split dollar (or shared ownership) arrangement, each owner of the contract would have a unique interest in the contract, and each interest would theoretically have its own cash surrender value and adjusted cost basis. While the two cash surrender values would add to the total cash surrender value of the policy, the two ACBs would not necessarily add to the ACB of the whole contract as tracked by the insurance carrier.

It should be noted that while the Income Tax Act defines the disposition of a life insurance policy, these same provisions do not extend to a disability insurance policy, a critical illness insurance policy, or a long-term care insurance policy. Tax treatments surrounding the disposition of these types of insurance policy are not clearly addressed in the Income Tax Act.

A life insurance policy is a unique type of property, and the special rules that apply require a knowledgeable professional to determine the results that could be expected from a transaction involving such a contract.

I/R 7401.043

Charitable Gifting Of Life Insurance Policies

The gifting of a life insurance policy to a charity has some unique advantages. However, there are also some hurdles to overcome.

When a person donates a life insurance policy to an eligible charity, the policyholder will be considered to have disposed of the policy and to have received deemed proceeds of the disposition for an amount equal to the cash surrender value of the policy. This will result in a taxable policy gain for the donor, in that tax year, to the extent the policy's cash surrender value exceeds the donor's adjusted cost basis.

As per the Canada Revenue Agency's current administrative position (which can change as it does not have force of law), when a gift in kind of a life insurance policy is made to a charity, the charity is able to issue a receipt for the fair market value of the policy.

Consider the following example:

	$
Death benefit under the policy	1,300,000
Cash surrender value of the policy	400,000
Adjusted cost basis of the policy	250,000
Fair market value of the policy	600,000
Charitable receipt	600,000
Proceeds of disposition	400,000
Policyholder's ACB	250,000
Policy gain (proceeds less ACB)	150,000

It should be noted that in the above example, the fair market value of the life insurance policy was determined by a qualified independent actuary. This is an important step in any arrangement where the policy has a fair market value in excess of its cash surrender value, as the charity needs to be able to substantiate the fair market value of the policy in order to issue a charitable receipt for that amount.

The CRA has listed the type of factors it would consider in the valuation of a life insurance policy in Information Circular 89-3, paragraphs 40 and 41:

a) cash surrender value
b) policy's loan value
c) policy's face value
d) state of health of the insured
e) conversion privileges
f) other policy terms, and
g) replacement value

One of the hurdles that must be addressed when gifting a policy is the proposed charitable tax shelter regime. Proposed on December 3, 2003, a new anti-avoidance provision sets up a deeming rule for the value of gifts in kind. This new rule will apply when the property is acquired less than three years prior to the time of the gift, or less than 10 years prior to that time, if it is reasonable to assume that the property was acquired to eventually be gifted. The new rule states that the fair market value of gifted property is deemed to be the lesser of fair market value of the property and the cost of the property, or in the case of capital property, the adjusted cost base of the property.

The phraseology of the new provision creates an interesting situation in the case of a life insurance policy because 'cost' is not defined in the Income Tax Act. Since the legislative drafters did not use the term 'adjusted cost basis', it would suggest that cost may refer to something other than the adjusted cost basis.

For newly acquired policies that are gifted immediately to a charity, the charity may be able to issue a receipt for the 'cost' of the policy. The 'cost' of the policy might be determined as the unused portion of the premium. For example, an individual purchases a new policy on his or her life with a $1,000 payment representing one month's premium, and then immediately assigns ownership of the policy to a charity. The charity may be able to issue a receipt for $1,000, or perhaps $966.67, which represents 29 days out of a 30-day month.

For older policies that are gifted to a charity, the individual will have to document when the policy was last acquired, and why the policy was acquired. Care will have to be exercised in those situations where individuals move policies around to suit their changing circumstances. Changes of ownership within the three years prior to donating the policy will result in a donation amount equal to the 'cost' of the gift, not its fair market value. Changes of ownership within the last 10 years will have to be reviewed for the 'purpose' of the transfer.

Planned giving with life insurance has the ability to turn otherwise small gifts into substantial gifts. However, careful planning is key to ensuring the intended results for the donor and the charity.

I/R 1600.02

Income Splitting

Frequent commentary in the press highlights the concept of reducing income tax through "income splitting", with articles often discussing who might benefit, along with ways to avoid certain tax rules in an effort to lower the overall tax bill of a couple or family.

The decision to use an income splitting strategy should be based on whether the strategy suits a person's or a family's needs and overall objectives, and on simple economics. Income splitting should be initiated only if income currently taxed to one taxpayer can be split with another taxpayer, if the end result does not lead to an undesirable imbalance within the family, and the overall tax savings – mainly through differences in marginal tax rates – exceed the costs of setting up and maintaining the program. The personal, family, and financial benefits should exceed the costs for it to be worthwhile.

Income splitting techniques are many and varied:

- One spouse can contribute to a spousal RRSP for the other spouse
- Married seniors can split their eligible pension income
- Married seniors can split their Canada/Quebec Pension Plan income
- Business owners may be able to pay their children and other family members an income for work done for the company
- Spouses/parents can lend funds to their spouse or adult children for investment income splitting, with careful documentation and attention to detail
- Business owners can reorganize and allow their spouse or children to subscribe for new growth shares

Spousal RRSPs are simple to establish and can increase the income splitting opportunities at retirement. Spouses may also have a bit more flexibility in determining who takes how much income from their RRSPs/RRIFs on a year-to-year basis. Once the spouse has turned 65, for example, a RRIF or registered annuity could be set up to take advantage of the pension tax credit. In addition, income from the spousal RRSP could also be eligible for the pension splitting election for the couple once the RRSP owner turns 65.

Pension income splitting is also fairly straightforward and requires only a tax form to be signed every year by both spouses. This means the couple could split income one year and change the amount split in a subsequent year, or even drop income splitting in order to minimize their combined tax burden on a year-to-year basis.

Splitting of C/QPP income has to be arranged with the pension authorities so each spouse actually receives his or her share of the income.

A business owner could have his company pay an income to his or her children or other family members. However, the family member will have to be providing services to the business, and the amount paid for those services must be reasonable, in order for the payment to be deductible to the business, and where the business is incorporated, for the parent to avoid the shareholder benefit rules. It should be noted that the company may also have to pay payroll taxes (CPP and EI) on these wages, under certain circumstances.

One of the less expensive methods of splitting investment income is to set up a legally binding loan arrangement with a spouse or other adult family member, to enable them to invest. A loan document would set out all the details of the loan, such as security, capital repayment, interest rate, and interest payments. Between spouses, the loan interest must be at least equal to the rate prescribed under the Income Tax Act at the time the loan is entered into. That loan interest must be paid in full every year, within 30 days after the end of the year, or the loan will forever after be 'offside', and the investment earned by the borrower will be attributable back to the lending spouse ever after. In addition, the cost of drafting the loan document could be significant, depending on the amount of professional assistance required. In addition to the setup cost, the taxpayers must remember to pay the interest annually, which is taxable to the first taxpayer but tax deductible by the second taxpayer.

More expensive income splitting options would involve trusts and holding companies. In these situations, the setup costs would be higher because a trust document needs to be drafted or a company needs to be incorporated. In addition, the ongoing costs need to be considered. The trust and the corporation would need to file annual tax returns that may require the assistance of a professional.

The value of such a structure would be income taxes saved. The potential drawback is that you have transferred value to others. It is no longer yours. But the value would be based on assumptions like the amount of income transferred and the difference between the applicable tax brackets. The analysis could look as follows. Note, however, that this is a simplified example, and "real" data will yield different results:

	A	B	C	D	E	F
Amount of interest income or taxable capital gain transferred	30,000	60,000				
Amount of eligible dividend income transferred			30,000	60,000		
Amount of ineligible dividend income transferred					30,000	60,000
Tax bracket of first taxpayer (utilizes Newfoundland 2009 tax rates for the provincial portion)	top 44.5%	top 44.5%	top 44.5%	top 44.5%	top 44.5%	top 44.5%
Taxes saved by first taxpayer	12,969	26,316	6,485	13,350	9,431	19,242
Tax liability of second taxpayer	6,615	16,999	140	5,902	2,144	8,927
Overall tax savings	6,354	9,317	6,345	7,448	7,287	10,315

For the sake of this analysis:

- In this case, the 2009 tax rates for Newfoundland & Labrador were chosen for the provincial portion of the total tax rate. To apply this type of analysis to other situations, a taxpayer would have to use the provincial tax rates from his or her own province of residence.
- The two taxpayers in this example are spouses, with the first spouse in the top tax bracket and the income of the second spouse equal to the provincial personal exemption of $7,778 in order to highlight the tax savings of income splitting.

The analysis presented is really only an example. The changes in tax savings will depend on a great number of assumptions that are unique in each situation.

Income splitting is a technique to lower the overall tax cost to the couple or family. However, care should be constantly exercised to ensure the benefits achieved are generating an overall economic profit, and the involvement of tax and legal professionals is essential in all but the more straightforward RRSP and TFSA arrangements.

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