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My Last Words (For Now)

As this is my last article for 2008, I thought I would take this opportunity to update you on some of the articles I have written this year.

For me, the most interesting article of the year was my October look at valuation and family business share structures, focusing on the control premium issue.[1] The article was prompted by a Vancouver tax file that was brought to national attention over the summer, where the CRA is apparently asserting that a significant control premium applies to voting shares held by an estate freezor. One thing that worried me as I was researching the article was whether I was about to make a fuss over what could be a local issue, or whether this had the makings of a Canada-wide problem for estate planners. But just as I was polishing off the article, the CRA issued a release confirming that, even in a "thin-voting" situation – where shares have no significant rights other than to vote, the CRA's opinion is that, while the amount would depend on the particular facts and circumstances, "a hypothetical purchaser would be willing to pay *some amount* for the voting control of a company".[2]

Control Premium and Family Law Issues

At the time I wrote the above article, my mind was on tax issues: obviously, the control premium might increase death tax exposure in an estate freeze. Also, if the CRA took the position that a very large control premium applied to so-called "exclusionary dividend" shares (e.g., two classes of common shares each entitled to dividends to the exclusion of the other class, but only one class has voting rights), this might undermine structures which seek to multiply the capital gains exemption.

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However, I have more recently been concerned with the fact that, in Ontario at least, the control premium issue could be significant in the family law context, e.g., where one spouse has voting exclusionary dividend shares and the other has non-voting exclusionary dividend shares or no shares. This could be a big problem for the spouse with the voting shares, or an opportunity for the other spouse, depending on how you look at it. I can see these structures becoming a battleground for well-to-do couples on the rocks – assuming, of course, that the business is still worth something. A key to the situation could be the perceived viability of a hypothetical oppression action against stripping the company. I think that this may depend a lot on the particular structure.

The CRA's policy on control premiums may also have an impact on an article written by my partner, Michael Goldberg, back in February. In "The Capital Gains Exemption: Keeping It Pure",[3] Michael described a number of structures that could be used to purify a company, so that it can continue to be eligible for the capital gains exemption. One of these, dubbed by Michael as the "*Neuman* Strategy",[4] may involve an exclusionary dividend structure whereby freezor, for example, retains one class of common shares (maybe a single share), with a family trust owning many shares of another class. The idea is that freezor's shares could be held by a holding company, so as to allow cash to be systematically dividended out to the holdco, enabling the operating company to continually qualify for the capital gains exemption. If these shares (i.e., held by father's holdco) are voting, as may often be the case, this could result in a valuation issue[5] which could undermine the freeze. In one case we are aware of, the CRA may be taking the position that virtually all of the value of a corporation's shares is attributable to the voting exclusionary dividend common shares.

TAX NOTES

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For CCH Canadian Limited

Robert Spenceley, Editor
(416) 224-2224, ext. 6279
e-mail: Robert.Spenceley@wolterskluwer.com

Robin Mackie, Director of Editorial
Tax, Accounting and Financial Planning
(416) 228-6135
e-mail: Robin.Mackie@wolterskluwer.com

TR Islam, Marketing Manager
(416) 228-6166
e-mail: TR Islam@wolterskluwer.com

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RETURN UNDELIVERABLE CANADIAN ADDRESSES TO
CIRCULATION DEPT.
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email circdept@publisher.com

Eligible Dividends – Here Today, Gone in 2012?

Back in May, I wrote an article on eligible dividends.[6] The 2008 federal Budget had proposed a change to the eligible dividend rules so that tax rates on eligible dividends would increase – to compensate for corporate tax rate decreases slated to be fully phased in by 2012. When I ran the numbers, I just about fell off my chair. By 2012, the differential at the federal level between eligible and ordinary dividends would be a mere .29%, with any remaining discrepancy attributable to provincial taxation. With the difference in federal taxation of eligible dividends all but eliminated, it seems hard to believe that the federal government will maintain this complex and often confusing regime. So, in keeping with my theory that a good tax practitioner should be able to predict the future, I predicted that the federal government will put an end to the eligible dividend regime in 2012. (This is not to be confused with the Mayan prediction that the world will end in that year – which I do not predict.)

But as we get toward provincial budget season, it will also be interesting to see whether the provinces step in to eliminate the differences in provincial taxation. Federal reductions start to begin in 2010 – i.e., just over a year from now. So, if the provinces want to match the phase-in, the next round of provincial budgets could be the time to do it. If so, we will have two parallel systems of dividend taxation – with all-but-identical results.

Tax Losses and the Market Meltdown

Last month, I wrote an article – "Tax Planning in Recessionary Times"[7] – focusing on tax-loss selling. The article largely assumed that losses on security sales would be on capital account. Typically, this is a reasonable assumption. But I can practically hear the calls from my accountant colleagues in March and April: "David, I have a client that really needs a refund. Can he claim his stock market losses as fully deductible?" (I actually received my first enquiry a few minutes after I wrote this paragraph.)

In anticipation of these calls, I have been thinking about it a bit.[8] One thing that has changed in recent years is that a lot of investors have managed accounts. In many cases, the manager, who is obviously an investment professional, will make a great many trades, with a short holding period and very little attention to dividend yield. Some years ago, Ontario attempted to reassess a number of corporate taxpayers with high trading volumes (usually due to managed accounts) on income account.[9] There seem to be very few cases on managed security accounts;[10] a couple of fairly recent cases in the securities trading area have focused on the past consistency of the taxpayer in question. Advisors should think carefully about whether their clients want to have a close encounter with the CRA.[11] The CRA may hold them to income treatment if there are future gains, and even the possibility of a reassessment for prior years if the limitation period is still open. Your clients may tell you they'll cross these bridges when they come to them; but at least you've warned them (for what it's worth).

For clients who qualify for inventory treatment on a their securities portfolio, one bonus is that, if they missed the 2008 tax-loss selling deadline, it should still be possible to claim an inventory writedown based on year-end values[12] (in fact, the superficial loss I talked about last month and most other stop-loss rules are out the window). But if the securities start to appreciate in value, they have to be written back up, if they continue to be held by the same taxpayer.

– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide.

Notes:

1 "Valuation and Family-Business Share Structures – Some Musings", *Tax Notes*, No. 549, October 2008.

2 This statement was originally in the CRA's paper on the 2007 CRA Round Table, and was soon thereafter incorporated in Technical News No. 38. The CRA also confirmed its policy on family control:

> When we value different classes of shares in a company, we generally determine the "*en bloc*" fair market value and then allocate the value to each class in isolation. The fair market value of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class. In other words, we consider what a hypothetical arm's-length purchaser would be willing to pay for a particular class of shares based on the rights, restrictions, and conditions, which ultimately affect the economic benefits to be derived from ownership. Given the above, there may be many factors which might influence the value of voting control.

3 *Tax Notes*, No. 541, February 2008.

4 After the famed dividend splitting case that went up to the Supreme Court of Canada: *Melville Neuman v. The Queen*, 98 DTC 6297.

5 Assuming, of course, that freezor controls his holdco.

6 "Eligible Dividends – A Prediction", *Tax Notes*, No. 544, May 2008.

7 *Tax Notes*, No. 550, November 2008.

8 For a recent discussion of this issue, see (for example) "Stock Market Losses: Might They Be Fully Deductible?", R.G. Fitzsimmons, *Tax Topics* No. 1882, April 3, 2008 (the author suggests a rather novel "point system" for assessing a taxpayer's case for capital gains status).

9 See "Ontario's Capital Gains Snafu", *Tax Notes*, No. 484, May 2003.

10 One case is *Vancouver Art Metal Works Limited v. The Queen*, 2001 DTC 5337 (FCTD). (This is a different case than the 1993 Federal Court of Appeal judgment involving the same taxpayer, which determined that, in respect of the "Canadian securities election" (subsection 39(5)), the words "'trader or dealer in securities' are broad enough to include anyone other than a person engaged in an adventure or concern in the nature of trade.") The 2001 case determined the actual issue of whether capital gains status applied and supported capital gains status, notwithstanding the managed account, but indicated that income or capital gains status is a question of fact. *Karben Holdings Ltd. v. The Queen*, 89 DTC 5413 (FCTD) held that income status applied, citing volume of transactions, extremely short holding periods, the nature of the securities, financing arrangements, and the time spent on trading activities.

11 The loss would be reported on line 135. Presumably, form T2124 would be filed. For many taxpayers, this would be a "one-shot" filing. Compliance costs should be considered.

12 In this case, the values are based on December 31 amounts, rather than the values on December 24, which is the last day to trigger a capital loss in 2008 on Canadian exchanges.

Tax-Free Savings Accounts

Perhaps not since the hula hoop, pet rocks, and the latest *Indiana Jones* movie has something caused such buzz on Main Street. Everyone is talking about the new tax-free savings account ("TFSA") created in the 2008 Budget. Starting in 2009, resident individuals at least age 18 may establish one or more TFSAs through Canadian financial institutions. This new savings vehicle has attributes similar to our existing savings regime, and some nifty new features of its own. Like RESPs, but unlike RRSPs, the capital contribution does not generate a tax break, nor is the withdrawal of capital taxed. Unlike either of them – and here is the excitement – the accumulating investment income that the account earns is never taxed! Similar to RRSPs, new contribution room accumulates annually, although it is not tied to generating "earned" income. Rather, universal annual room starts at $5,000 in 2009 and is scheduled to be indexed every year in the future. You may contribute up to your accumulated room at any time in your life. Excess contributions are subject to a 1% per month penalty, as with RRSPs.

The investment rules of TFSAs generally will be the same as those that govern RRSPs, including the point that borrowing to contribute does not create deductible interest. Investment management and brokerage fees are directly deductible when incurred in a non-sheltered account, and effectively deductible when incurred in a sheltered account, but they will not be deductible for TFSA accounts.

Unlike RESPs (and special purpose education and homebuying in RRSPs), TFSA funds can be withdrawn at any time for absolutely any purpose in life. Unlike RRSPs and RESPs, you may withdraw funds from the TFSA and replace them at any time, starting in the calendar year after the year of withdrawal. In effect, then, your accumulating room, and accumulating income thereon, is a lifetime balance in the account that can ebb and flow depending upon your needs.

Existing attribution rules between spouses are irrelevant for TFSAs because they are tax-free. Thus, one spouse can fund the other's TFSA contributions. Unlike RRSPs, however, one's own TFSA contribution room must be contributed to one's own TFSA, and cannot be "spousal".

The tax treatment of TFSAs upon death will parallel RRSPs. The account can transfer directly through a "named beneficiary" election, or indirectly through the will, to a surviving spouse and retain the tax-free character. If the TFSA is inherited by someone other than a spouse, the accumulated amount at death passes tax-free to the beneficiary but the income earned in the account after death becomes taxable. In the case of capital assets (e.g., stocks), these will be marked to market upon the death, and only the gains (or losses) from this value will have a bearing for the beneficiary.

A related matter remains to be seen in the detailed legislation. In the case of the RRSP of a deceased, the executor can make a post-mortem RRSP contribution under the normal deadlines for the final tax year of the deceased. For a TFSA, will the executor be able to pay back funds borrowed at the time of death? This would be useful where there is a surviving spouse, who can then carry forward a larger TFSA account.

Like RRSPs, TFSAs can be transferred in a marital breakup.

Unlike RRSPs and RESPs, there are no age implications to TFSAs (other than attaining age 18).

Unlike RRSPs, however, the assets in a TFSA can serve as collateral against a loan.

An interesting twist is that individuals who cease Canadian residency may maintain their TFSAs and continue to earn income free of Canadian tax. No contributions may be made, however, and no annual new room will accrue. Also, any withdrawals made while non-resident may not be repaid subsequently. There likely will be tax liability, however, in the new country of residence with regards to the investment income earned in the Canadian TFSA.

Who is a good candidate to use TFSAs?

People who want a rainy day fund

Everyone can build a savings pot which earns tax-free investment income until that unexpected expenditure arises.

Low-income people

Conceptually, TFSAs were originally intended for people with low income throughout their working careers and retirement years. They would receive low marginal tax value from making RRSP savings while working. Then they would be penalized in retirement by turning that RRSP into a pension stream which might preclude them from receiving various income-tested social welfare benefits. Now, a TFSA can build up retirement savings without impairing access to these benefits.

In fact, it may be wise for low-income people to draw down their existing RRSPs before retirement to protect the entitlement to these social welfare benefits after retirement.

People who have topped up all of their RRSP contribution room

The TFSA provides another tax-incented savings vehicle when RRSP room is exhausted.

Parents who wish to help their adult children

In the past, parents might have assisted their children's house acquisition with a lump-sum gift or loan. In the future, they might accumulate their own TFSAs to save for this purpose, or perhaps fund their children's TFSA contributions towards the same purpose. Thought should be given to whether this is a gift or a loan, and the latter ought to be documented on paper in case the child's marriage should fold; otherwise, the ex in-law may walk away with half of the money.

People who wish to accumulate funds for future large expenditures, like a house, car, return to school, or family wedding

We have had a smorgasbord of savings vehicles in the past, like RHOSPs, Home Buyers' Plans, and Lifelong Learning Plans. The TFSA may be a neat and tidy one-stop shopping vehicle for these purposes in the future.

Couples with disparate incomes

Tax law thwarts various income splitting schemes between couples; however, annual TFSA contributions for a low or no-income spouse can be funded by the high income spouse, without attribution.

Parents who wish to accumulate a large education savings pool for their children

Perhaps expensive schooling is anticipated for medical or grad school or Ivy League education. RESP accumulations may not be sufficient to prepare for this. Parents could augment in their own TFSA accounts while the children are young and could contribute to their children's accounts after age 18.

People with fluctuating incomes

It is smart to use RRSP contributions as deductions when your marginal tax bracket is high – this increases the tax break associated with the contribution. One's income might fluctuate for a variety of reasons; e.g., being in and out of the workforce, having performance-based compensation (e.g., a realtor), or having large one-time income, like capital gains on real estate. In the past, one might make that RRSP contribution (with available cash) but defer the deduction claim until a better time. A problem with this is that one doesn't know when, or if, a big income year will come. But now, it may be wiser to contribute the funds to a TFSA, earn tax-free income along the way, and withdraw the funds to make an RRSP contribution when that big income year arrives. The withdrawal from the TFSA only "borrows" from your room and can be replaced another day.

An opportunity exists for the charitably minded who experience a high-income year. They might borrow from their TFSA to make a large donation to offset their high-income year. That money could be paid back to the TFSA any time in the future, or not.

Note that the relatively new, and generous, stock-gifting-in-kind tax law is irrelevant and inappropriate for any appreciated stocks in a TFSA. The capital gain in the TFSA is tax-free anyway, so this generous tax rule belongs exclusively with appreciated stocks in a Direct Trading account. On the other hand, the appreciated stock in a TFSA could be sold (tax-free) and then the cash borrowed from the TFSA could be donated.

People who anticipate large estate taxes on death

Large death taxes can arise from deemed RRIF deregistration and from deemed capital gains on stocks, real estate, and recreational properties. Traditionally, death taxes are funded either from liquidations in the estate wind-up or from some form of life insurance. TFSAs may cut into future insurance policy sales as a new, effective and cheaper means to fund these death taxes, as well as lower the death taxes themselves.

Recent retirees under age 71

To lighten the tax load in retirement transition, recent retirees might augment their lifestyle costs by drawing down their TFSAs instead of their sheltered accounts. This allows their sheltered accounts to compound through their '60s.

People who wish to fine-tune their financial management by addressing tax-smart investing strategies

This area is complex and depends upon your investment profile and marginal tax bracket. The topic is discussed below.

Prioritizing savings goals

For starters, it will be wise for anyone and everyone to use some TFSA room to finance their rainy day emergency fund and enjoy the tax-free aspect of this new account.

After building your emergency fund, determine your medium-term savings goals and prioritize them by their timelines. For instance, if house acquisition is top of the list, ensure that both of the couple have accumulated $20,000 in their RRSPs that can be withdrawn under the Home Buyers' Plan. If not, make RRSP contributions accordingly. After this, each of the couple should save through his or her TFSA room, followed by a non-sheltered account.

Education savings through RESPs needs attention next. This is particularly true if your children are older – the timeline is short to contribute, use up their lifetime room, and enjoy the significant 20% matching grant.

When your savings goals become long term, i.e., retirement, you need to determine what annual savings rate is required and affordable. Then determine if your annual savings rate is more or less than the sum of your TFSA and RRSP contribution room (we'll call this sum your "total room"). If your annual savings rate is less than your total room, save first in a sheltered account if you are not in a low tax bracket, and then in a TFSA. If you are in a low tax bracket, save in reverse order, starting with the TFSA. If your annual savings rate exceeds your total room, save first in a TFSA and in a sheltered account until you have used your total room, and then in a non-sheltered account.

If your ability to save precludes you from maximizing both of your TFSA and RRSP limits, then you must decide which of those two accounts will receive your scarce capital. The trade-offs between TFSAs and RRSPs include both tax-smart investing issues plus the tax break received from RRSP contributions (but not from TFSA contributions). Academic research has performed some number crunching on this and concluded that it may be a "wash", depending upon your income level.

Funding strategies

A working couple without a company pension plan could have as much as $40,000 in annual RRSP room plus $10,000 in TFSA room plus RESP room for their children at $2,500 each. This starts to add up to a lot of money – perhaps more than can be put aside in annual savings. If so, then some of the "saving" might instead be "switching". For instance, the annual TFSA contribution might be funded by transferring money, or investments, from a pre-existing taxable account. The win here is conversion of that wealth to earning tax-free instead of taxable. Note that where investments are transferred, that will be considered a disposition for tax purposes, and the treatment likely will be "one way" – meaning that gains will be taxable and losses will be denied. As such, it would be wise to choose carefully what "things" you transfer.

Tax-smart investing strategy

This area is complex and will get interesting. Let's start with a survey of existing tax law (as it pertains to B.C. residents).

Tax Treatment of Investment Income

	Non-sheltered account*	Sheltered account	TFSA
Interest	Fully taxable – annually	Fully taxable – but deferred to withdrawal	Tax-free
Dividends – eligible	Largely tax-free for incomes under $75,000 and taxable annually at rates from 8%–18% thereafter	Fully taxable – but deferred to withdrawal and significant dividend tax credits lost	Tax-free – but hefty dividend tax credits foregone
Dividends – ineligible	Taxable annually across all income levels at rates from 2%–32%	As above, except value of foregone dividend tax credit is less	As above, except value of foregone dividend tax credit is less
Dividends – foreign	Fully taxable annually and subject to foreign tax, and foreign tax credit, of 15%	Usually exempt from foreign tax withholdings	Subject to foreign tax withholding with no Canadian offset relief
Capital gains	One-half is tax-free	Fully taxable – but deferred to withdrawal	Tax-free
Capital losses	One-half is tax deductible, but only against any capital gains	Fully deductible, in effect, because the experienced loss creates less income to withdraw and pay tax on	Not tax deductible

* full details of these tax rates appear on our Web site at www.nilsonco.com.

The following chart ranks by column the three kinds of investment accounts by their tax treatments of various kinds of investment income.

	Most favoured	In between	Least favoured
Interest	TFSA	Sheltered	Non-sheltered
Dividends – eligible*	Non-sheltered	TFSA	Sheltered
Dividends – eligible**	TFSA	Non-sheltered	Sheltered
Dividends – ineligible	TFSA	Non-sheltered	Sheltered
Dividends – foreign	TFSA	Sheltered	Non-sheltered
Capital gains	TFSA	Non-sheltered	Sheltered
Capital losses	Sheltered	Non-sheltered	TFSA

* taxable income under approx $75,000.
** taxable income above approx $75,000.

There are a few practical issues with these observations. First, ineligible dividend income (from a private company) is relatively rare in sheltered and TFSA accounts. Second, dividends, capital gains, and capital losses are not easily separated – they tend to come all together. So, the only totally valid tax-smart statement is that interest income is preferentially treated in a TFSA.

These observations provide us with some guidelines on how to construct tax-smart investment portfolios across asset classes.

Tax-smart investing and asset allocation strategy

In economic history, David Ricardo inspired international trade by introducing his concept of "comparative advantage". He believed that, even when one trading nation was absolutely more efficient than another trading nation in producing every single good, it was still advantageous for the inferior nation to produce something, and for the two nations to trade. The more efficient nation ought to focus on the goods for which it had the highest relative, or "comparative", advantage and leave the other goods to the inferior nation.

And so, David Ricardo leaves a legacy today for the world of tax-smart investing in the new TFSA era. From the fact that all forms of investment income are tax-free in a TFSA, it obviously has an absolute tax advantage over sheltered and non-sheltered accounts. However, TFSAs have relatively less advantage with some types of investment income than others. Also, in infancy, TFSAs are constrained in size (and will be for a generation or more), thus causing sheltered and non-sheltered accounts to remain in the investing picture. TFSAs have their highest comparative tax advantage with interest income and their least advantage with capital losses, followed by eligible dividends for those with incomes under $75,000. For the other types of investment income, the comparative advantage ranking varies with income level.

The right tax-smart asset allocation strategy depends upon which kinds of accounts you have, what their relative sizes are, and whether you have multiple goals with differing time horizons or just one goal, e.g., retirement saving. You should start with an overall asset allocation strategy and then set sub-strategies across whatever kinds of accounts you have, such that the sum of the parts attains the whole.

If you are saving for short-term goals, you may not be wise to undertake much, if any, risk in equities, given what can happen in the marketplace. Thus, all of the accounts you have should accumulate fixed income.

For people with incomes under $75,000, the tax advantages are fairly clear that they should focus on earning interest income in their TFSA and their RRSP and use their non-sheltered account, if they have one, for equity investing.

For pure capital gain plays, non-sheltered accounts are the best, given that the gains are speculative and that losses can net against gains over time.

For pure eligible dividend plays, e.g., preferred share issues, non-sheltered accounts are the best for incomes under $75,000, because the rich dividend tax credits make the dividend income tax-free, and in fact can even reduce the tax on other income.

If you have only TFSAs and RRSPs and are a long-term buy-and-hold equity investor who buys mutual funds or ETF indices, then you probably are safe to use your TFSA for equities.

For conservative investors with small equity allocations, fill the fixed income component of your asset allocation strategy in your TFSA and sheltered accounts, and use your non-sheltered account to fill the small equity component.

If you are saving for intermediate-term goals, like a house, start your fixed income in the sheltered account, your equities in your non-sheltered account and complete the overall asset allocation strategy in the TFSA.

For balanced investors with two accounts, start by filling the fixed income component of your asset allocation strategy in a TFSA and then place the rest in your sheltered account. Execute the equity allocation in your sheltered account.

For balanced investors with all three accounts, start to fill your equity component in your non-sheltered account and complete it, if necessary, in the other two accounts.

In summary, our financial institutions all will be coming forward with their TFSA "products" in the near future. Many Canadians likely will jump on the TFSA bandwagon quickly. The size constraint of these accounts will make them administratively unprofitable for the financial institutions for a long while. Those same size constraints also will minimize and delay the overall impact on Canadians' wealth picture.

To paraphrase and modernize a saying of 16th century Sir Francis Bacon: Family finances, to be commanded, must be obeyed. Those who seek to manage their finances need to pay attention to this new "kid on the block" – TFSAs.

– Don Nilson, FCMA, CFP, TEP, Principal – Nilson & Company/AFT Trivest Management

2009 Employment Insurance Premiums

On November 14, 2008, the government announced that the 2009 Employment Insurance premium rate is $1.73, unchanged from 2008. The employer rate is 1.4 times the employee rate. The 2009 premium rate for Quebec is $1.38. The 2009 maximum insurable earnings is $42,300, up from $41,100 in 2008.

"Return of Premium" of a Life Insurance Policy: a Misnomer?

White v. The Queen, 2008 DTC 4428 (Tax Court of Canada, Informal Procedure)

This Informal Procedure case from the Tax Court of Canada considered the taxation of a "return of premium" payment under a life insurance policy. As this case illustrates, a return of premium payment represents income earned by the taxpayer over the term of the policy and, for tax purposes, is not merely a return of the after-tax dollars used to purchase the insurance.

In 1983, the taxpayer purchased a term life insurance policy which included a "return of premium" benefit. The policy terminated in 2005 and because the taxpayer survived the termination of the policy, he received a cheque from the insurer representing his return of premium benefit. The Minister reassessed the taxpayer, adding the return of premium payment to the taxpayer's income. The taxpayer appealed.

When a policyholder disposes of an interest in a life insurance policy, paragraph 56(1)(*j*) and subsection 148(1) of the Act provide that the amount by which the proceeds of disposition of the interest exceeds the adjusted cost base to the policyholder is included in the policyholder's income. Mogan, J. noted that this gain is taxable as income, even though phrases like "proceeds of disposition" and "adjusted cost base" are typically used in the Act in regard to capital gains.

Subsection 148(9) of the Act defines terms for the purposes of section 148. "Disposition" includes the dissolution of an interest in a life insurance policy by virtue of the maturity of the policy, and the "proceeds of disposition" of such an interest means the amount that the policyholder is entitled to receive on a disposition of the interest. The definition of "adjusted cost base" contains 13 elements; the relevant ones in the context of this case were A, the total of the costs of the interest in the policy, and L, the net cost of pure insurance in respect of the interest.

The taxpayer had paid a total of $22,090.37 for pure insurance and the return of premium benefit – A, and the net cost of pure insurance for his policy was $21,069.17 – L. As a result, the taxpayer's adjusted cost base was $1,021.20. Subtracting this amount from the proceeds of disposition of $24,909.20, the taxpayer's gain was $23,888.

Mogan, J. expressed sympathy with the taxpayer's frustration: the premiums paid for the policy were not deductible in computing the taxpayer's income; thus they were paid with after-tax dollars. As a result, the taxpayer believed that the "return of premium" benefit was a return of after-tax dollars and a non-event for tax purposes.

Mogan, J. noted that the phrase "return of premium" accurately describes the quantum of the benefit that the policyholder is entitled to receive, but stated that the phrase is misleading because (i) the insurer was not "paying back" the premiums since the taxpayer had full value of life insurance for the duration of the policy, and (ii) the return of premium payment was not, in a business or tax sense, part of the taxpayer's premiums, but would more accurately be described as a share of the income earned by the insurer over the term of the policy from the investment of the additional premium that the taxpayer had paid for this benefit. The Minister had called an expert from the insurer, who explained that return of premium benefits are partially funded from investing a portion of the premiums received from policyholders, and are also subsidized by other policyholders who forfeit their right to a return of premium.

The taxpayer's appeal was allowed in part, as the Minister's reassessment had not deducted the taxpayer's adjusted cost base from the return of premium payment to calculate the taxpayer's gain on the payment.

Accordingly, this case demonstrates that the receipt of a return of premium benefit on the termination of a life insurance policy will generally be a taxable event and is taxable income for the policyholder by operation of the provisions of the Act governing the disposition of an interest in a life insurance policy.

– Jeffrey Love, McCarthy Tétrault LLP

CCH a Wolters Kluwer business

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca