ESSENTIALS OF CANADIAN TAXATION IN THE LIFE INSURANCE UNDERWRITING FRAMEWORK

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Executive Summary *Originally presented during an ALU webinar on July 23, 2014, the presentation discussed, in a simplified manner, specificities of the federal Canadian taxation for individuals, corporations, capital properties, trusts and life insurance within the life insurance underwriting framework. It aimed at providing a broad understanding about selected underlying tax principles that govern advanced life insurance marketing concepts.*

Introduction

Taxation is a vast, complex and – for many of us – daunting subject mostly addressed by experts. However, the life insurance underwriter will come across underlying taxation concepts while reviewing applications from high net worth clients, their estates and their trust arrangements.

Federal taxation at a glance

Three types of entities are subject to federal *income* taxation in Canada:

- Individuals
- Corporations
- Trusts

Each is required to file income tax returns (T1 for individuals, T2 for corporations and T3 for trusts). While the Income Tax Act determines the relevant tax rates for these groups, it also permits legitimate tax-planning opportunities through tax reduction, tax deferral or income splitting.

Tax reduction
The capital gain deduction is the most significant tax-reduction tool. This is discussed in more detail below.

Tax deferral
Employer contributions to a registered pension plan (RPP) are eligible for tax deferral. The benefit is not taxed in the year of the contribution but rather when the registered pension plan distributes benefits to the employee, and presumably would be taxed at a lower marginal income tax rate.

Income splitting
Since Canadian federal income tax rates are progressive (i.e., the marginal tax rate increases as taxable income increases), income splitting between two or more people within a family reduces the overall tax burden. Licit income-splitting arrangements were complex and expensive to implement, and were largely inaccessible to all but wealthy individuals. At the time of this writing, the Canadian government announced, at the end of October 2014, new legislation to allow income-splitting arrangements for all Canadians, not only for retirees.

Taxation of individuals

All Canadian residents and non-residents, regardless of citizenship, are liable for federal income tax for any income received from employment, business they have conducted or taxable property they have disposed of while working or residing in Canada.

Personal income tax rates (2014)
Federal tax rates for individuals are progressive after the deduction of a basic personal credit of $11,038 – i.e., higher rates are applied to higher marginal levels of income [see chart next page].

Taxation of unincorporated businesses
For income tax purposes, unincorporated businesses such as partnerships and proprietorships are flow-

Taxable income	Federal marginal rate[1]
$0-$43,562	15%
$43,563-$87,122	22%
$87,123-$135,053	26%
$135,054+	29%

[1] Before provincial income tax. The highest combined federal and provincial margin tax rate is for income taxpayer in the province of Quebec (47.5%).

through (pass-through) entities. Income earned (or losses incurred) by such organizations is allocated and taxed accordingly in the hands of the partners (individuals, corporations or trusts).

Planning for retirement with tax-assisted savings arrangements
The Canadian federal income tax system contains provisions to encourage private retirement savings that supplement the basic governmental plans. Annual contributions are limited to 18% of the taxpayer's annual income from the previous year. These plans include significant tax advantages:

- *Tax deferral advantages at retirement*: For some, retirement income may be sufficiently reduced so that they could find themselves in a lower tax bracket compared to when they were working. Benefits may be taxed at a lower rate due to lower overall income.
- *Tax-free build-up*: Investment income earned in these plans grows tax-free until distribution. The compounding effects over a long period of time provide for significantly larger accumulation.

Taxation of corporations
Since 2012, the *federal* corporate income tax rate has been 15%, and 11% for corporations claiming the small business deduction.

Small business deduction
The small business deduction (SBD) of 17% applies to corporate taxes for Canadian Controlled Private Corporations (CCPCs). The reduced tax rate is available on active business income (ABI) up to $500,000.

Taxation of corporate dividends
When a corporation decides to distribute retained earnings to shareholders, it pays a dividend from the company's *after-tax profits*. These corporately taxed dividends are further subject to personal income tax at the dividend recipient's rate. However, a taxpayer can claim a tax credit on dividends received from taxable Canadian corporations. A single individual whose only income is taxable Canadian dividends eligible for the SBD tax credit can receive approximately $43,430 before any federal taxes are due (compared to the personal income exemption of $11,138 mentioned earlier).

Small business owners: Dividend or salary?
This discrepancy can create a dilemma in determining owner-manager compensation:

- Earn a salary, which essentially transfers taxable income from the corporate to the individual level, or
- Pay through taxable dividends, which leave taxable income within the corporation, but result in a second level of taxation at the individual level.

In theory, the Canadian taxation system is designed to create overall tax neutrality with respect to compensation through either salary or dividends. This equality is referred to as *integration*.

However, some tax issues must be considered. Small business owners remunerated *solely by dividends* cannot contribute to a Registered Retirement Saving Plan (RRSP), as the RRSP deduction limit is based upon earned income (i.e., not dividends). Furthermore, the Canadian Pension Plan (CPP) benefit decreases significantly since an individual may not contribute to the CPP unless he is paid wages or earns self-employment income.

Taxation of capital gains on capital properties
Capital gains taxes replaced the inheritance tax in 1972. Under these rules, one-half of the gain (*inclusion rate*) is taxable at the individual's maximum marginal tax rate. In 1985, a lifetime capital gain deduction was introduced, originally set at $500,000 on the disposition of any type of capital asset. The current, inflation-indexed deduction on gains from the disposition of shares in a qualified small business corporation[2] is $750,000, and $800,000 for a qualified farm or fishing property for 2014.

Definition of capital gains (loss)
Capital gains (losses) occur when a taxpayer disposes of a capital asset for more (less) than the original cost. To qualify as capital asset, the property must be held for income-producing purposes (not for a quick resale at a profit). Otherwise the gain is considered income for tax purposes and loses the more favorable capital

[2] To qualify as a QSBC, a company must be a Canadian-controlled private corporation, and at least 90% of its assets must be used in an active business in Canada.

gains treatment. The gain is calculated by deducting the original cost of the asset from the proceeds received on the sale of the asset (see adjusted cost base).

Adjusted cost base
The adjusted cost base (ACB) of a capital asset is similar to the accounting concept of the book cost, i.e., the initial capital costs (original purchase price plus all acquisition costs) to the taxpayer. The ACB is used in the calculation as the original-cost basis for determining the net gain at disposition or sale.

Death of the taxpayer
A deceased taxpayer is deemed to have disposed of his capital properties at fair market value immediately before his death (*deemed* disposition). At the same time, the property receives a step-up in basis equal to its current fair market value for the acquirer, unless the property has lost value from the original-cost basis. Such depreciable property must retain the original-cost basis (the undepreciated capital cost, or UCC), with the difference being treated as deemed capital cost allowance to the new owner.[3] Of note: The *primary* residence is exempted from any capital gain/loss considerations.

Rollover exemption
The Income Tax Act provides an exemption for a transfer to a spouse, a common-law partner, or a testamentary spousal or common-law trust. This is known as the *rollover provision* whereby the transfer of non-depreciable property occurs at its ACB and depreciable property at its UCC. The transfer doesn't generate a capital gain or loss, and the surviving spouse will assume the same property value treatment as originally carried by the deceased. This defers any capital gains determination until the surviving spouse disposes of the property or dies. However, the estate settlor may elect to have part or all assets transferred at fair market value, thus triggering *immediate* capital gain taxation.

Taxation of personal trusts
Trusts are powerful – increasingly complex – tax-planning tools. They can provide a convenient and cost-effective mechanism for:

- Splitting large amounts of capital property among family members; and
- Accessing deferred and income-splitting opportunities present in estate-freeze transactions.

[3] A CCA is a yearly deduction or depreciation on the cost of certain assets. In the year a depreciable property such as a building is bought, the full cost cannot be deducted. However, since this type of property wears out or becomes obsolete over time, its capital cost can be amortized over a period of several years.

Flexibility in income taxation of personal trusts
Trust income is taxed in the same manner as individuals, though without many of the tax credits available to individuals. Furthermore, determining who will be taxed is flexible. If the trust agreement requires the income to be paid to beneficiaries, generally the beneficiaries will be liable for tax. However, it's possible to have some or all of the income taxed in the trust. For *testamentary trusts*, the same progressive tax rate is applied as for individuals. *Inter-vivos trusts* are subject to a flat federal tax rate of 29% on all trust undistributed income. Because the 29% rate equals to the maximum marginal paid by beneficiaries receiving income, incentives for accumulating income in an inter-vivos trust are low.

Taxation of capital gains within a trust
Capital gains held within a trust are considered an addition of capital and, in the absence of special trust provisions, are not payable as income to the trust beneficiary(ies). Thus, if the taxable portion of trust income is not paid out, it will be taxed within the trust, separate from the tax-exempted portion of the trust's capital, which can be distributed tax-free.

Taxation of dividends paid by a trust
Inter-vivos trusts have all investment income taxed at the maximum tax rate of 29% from the first dollar. In testamentary trusts the effective tax rate for non-eligible dividends is 2.08%, including the gross-up and the dividend tax credit. Eligible dividends are generally paid tax-free from testamentary trusts.

The 21-year deemed disposition rule
Capital gains held in a trust may accumulate tax-deferred for extended periods of time. Unless the assets are sold or distributed by the trust, any accrued gains will not be taxed. To limit this deferral process, personal trusts must, on paper, dispose of all property every 21 years for proceeds equal to the fair market value at disposition, and "reacquire" the assets at the same value. This event triggers a taxable capital gain (loss) and a step-up in basis. There are some exceptions:

- For qualifying spousal (or common-law partner) trusts, the deemed disposition occurs with the spouse's death.
- For joint spousal (or common-law partner) trusts, the deemed disposition occurs at the later death of the settlor or the surviving spouse. For alter ego trusts, the death of the settlor triggers the deemed disposition.

Taxation of life insurance policies
Life insurance products have special tax exemptions, which make them useful tools for financial planning.

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Because of the many tax implications, choosing the ownership and beneficiary structure of a (permanent) life insurance policy can be particularly important and must be well planned before issue, specifically when the policy is purchased for advanced tax planning.

Tax-free death benefits
Life insurance proceeds are tax-exempt. The beneficiary is not liable for any tax or probate fees on death benefits, even if the policy owner is a trust.

Tax-exempt dividends
Policy dividends used to purchase additional insurance coverage (participating whole-life) are not subject to tax. Dividends paid out in cash are taxed as income.

Tax-exempt growth
Investment income inside a universal life policy accumulates tax-free within the parameters of a prescribed test policy as determined by the Income Tax Act (the *exemption test for exempt policies*). Excess investment income is taxed as income. However, Canadian insurers have implemented contractual or non-contractual measures to ensure that policies remain exempt from year to year.

Tax-deductible premiums
Typically, life insurance premiums are not tax-deductible. However, two exceptions exist:

- If the policy was purchased and a *registered charitable organization* was named beneficiary, then the policy owner can receive a charitable donation receipt.
- If the policy is a *collateral corporate loan requirement* by a chartered bank, a trust company or a credit union, a portion of the premiums for the policy may qualify as a deductible expense for a corporation.

Adjusted cost basis
The adjusted cost basis (ACB) is the cost of an insurance policy for tax purposes. In simple terms, it's the sum of the premiums paid less the net cost of pure insurance (NCPI).[4]

Capital dividend account for corporate or partnership-owned policies
All beneficiaries – individuals, trusts or corporations – receive life insurance death benefits tax-free. Corporations and partnerships can achieve proper tax inte-

[4] NCPI for a given policy year equals the net amount at risk (i.e., the total policy death benefit minus the total cash value) multiplied by a prescribed mortality rate for the insured's current age. It represents the mortality charge for the pure insurance element of the policy.

gration by using a notional corporate account called the *capital dividend account* (CDA). The CDA allows a Canadian private corporation to give shareholders designated capital dividends tax-free. The CDA is not recorded in the corporation's financial statements.

Policy dispositions and transactions
As a general rule, exempt life insurance policies are not subject to income taxation – mostly because they do not fall under the tax category of capital property, and no capital gain is realized – unless there is a premature or deemed disposition that triggers a taxable income on the policy gain. A taxable disposition can be:

- The partial or full surrender.
- A policy or premium loan.
- The transfer to a successor owner, or by right of survivorship in joint tenancy.

The following dispositions are tax-neutral:

- The assignment of all or part of the policy as *security for debts or loans*, other than policy loans.
- A *lapse* and then *reinstatement* of the policy during the calendar year of the lapse of within 60 days, thereafter.
- The transfer of ownership by way of *absolute assignments* to a spouse or a child.

Access to cash values by the policyholder
When cash is withdrawn from a policy (by means of loan or surrender), there is potential for taxation:

- *Policy surrender*: When a policy is surrendered (cashed in), the amount of income inclusion for the policyholder equals the cash surrender value less the ACB.
- *Policy loan*: Amounts up to ACB can be borrowed without any tax consequences.

Ownership transfers
Numerous rules and exceptions make the topic of the transfers of ownership of life insurance policies particularly complex, as applicable rules vary in different circumstances according to the relationship between the transferor and the transferee. As a general rule, an ownership transfer of a life insurance policy is a taxable disposition whereby:

- The original owner will include the policy gain (transfer price less ACB) in his taxable income for the year where the disposition took place; and
- The transferee will be deemed to have acquired the policy with an ACB equal to the transfer price at the time of the acquisition. This will become the new ACB of the policy.

Conclusion

Understanding basic taxation principles, rules and exceptions is a necessary prelude to understanding advanced life insurance concepts beyond personal and business protection needs (see the author's previous article published in the September 2013 *OTR* issue). Many of these concepts employ taxation arbitrage between personal, corporate and trust tax rates, and rules exceptions. Underwriters should challenge themselves to understand purposes of insurance involving complex tax strategies. Don't hesitate to drill your client's financial or insurance advisor if the purpose doesn't make much sense at first glance.

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About the Author
Philippe Aussel has more than 35 years of facultative reinsurance underwriting experience and has worked for SCOR Global Life (Canada) since 2003, having started at Munich Re (Europe) in 1977. *ON THE RISK* published an article by Philippe on "Essentials of Financial Statement Analysis and Business Valuation" in September 2012, and an article on "Advanced Life Insurance Concepts at a Glance for Underwriters from a Canadian Perspective" in September 2013. Philippe holds an insurance degree from the German Insurance Academy (Deutsche Versicherungsakademie) and in 1996 wrote his final study paper on "Financial Statement Analysis for the Non-Professional Reader."