



TAX PLANNING: UNUSUAL AND CONTROVERSIAL TAX STRATEGIES

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I. TRANSFER OF INSURANCE POLICIES TO COMPANY

The situation that is envisioned is where a person owns an insurance policy that is worth significantly more than the remaining stream of premiums. This is usually because of the health of the individual on whose life the policy is taken which may have deteriorated significantly from when the policy was issued. Alternately, if there is an “old” policy where the remaining premiums are significantly less than the premiums would be for a new policy, there may be value in the policy. It is assumed that the policy in question has little or no cash surrender value.

In such a case, the individual insured transfers the policy to his/her holding company and receives from the holding company an amount equal to the fair market value of the policy. (See paragraphs 40 and 41 of Information Circular 89-3 to determine the factors to be considered in valuing a life insurance policy.) The amount received will not be taxable to the individual. The net result of such a plan is the extraction, on a tax-free basis, of corporate surplus to the individual without any tax or benefit issues.

The reason for this result is because of the wording in subsection 148 (7) of the *Income Tax Act* (hereinafter “ITA”) which deems the “proceeds of the disposition” to the policyholder to be equal to the “value” of the policy. Based on the definition of “value” in subsection 148(9) of the ITA, since there is no cash surrender value at the time the policy is transferred, the “value” would be nil and so would the “proceeds of the disposition”. It follows that the cost of the interest to the corporation would also be nil.

On the death of the individual, it would appear that the CDA should be equal to the death benefit and, therefore, the insurance proceeds received by the holding company can exit the holding company, to the heirs, the whole without tax. This is clearly a case of “double dip”.

II. SHIFTING CAPITAL LOSSES TO THE SPOUSE WITH HIGHER CAPITAL GAINS

Assume Mr. X invests heavily in the stock market and usually has gains far in excess of losses. Mr. X would like to income split with his wife but would like to keep only the “winners” in her portfolio and would like to take the benefit of her “losers”.

The wife will buy a number of securities. It is presumed that the husband has capital gains this year (or in the past three years) and wants his wife to “max out” on as much capital gains as she can realize (it is assumed that there will be no attribution as the wife will be using her own money to purchase the securities). If there is a “loser”, the wife would sell the shares to the husband. (The husband can pay either in cash or by way of a promissory note; if a promissory note is used, interest at the prescribed rate should be paid.) The loss on the stock is denied to the wife due to the superficial loss rules and such loss is then added to the husband’s cost base.

The husband must wait 30 days after he acquires the stock before disposing of same in order to meet the criteria of the superficial loss rules. After 30 days, when the husband sells the shares, it will be his loss for tax purposes.

When the husband and wife file their tax returns, in order to avoid attribution of the loss back to the wife, they must elect out of the rules providing for an automatic rollover between spouses. An election out of subsection 73(1) ITA will allow the transaction to occur at fair market value and the attribution rules will not apply as the husband will have paid fair market value for the shares to the wife. Alternately, if the wife sells the shares on the open market and the husband buys the shares on the open market within 30 days (and he then keeps the shares for 30 days), this election out is not required.

III. CRITICAL ILLNESS

The usual critical illness policy provides for the payment of a lump sum if the insured develops one of a listed number of diseases. Typically, it is possible to purchase a “rider” pursuant to which there will be a refund of both the critical illness premiums and the rider premiums at the end of 15 years if no claim is made on the policy. As an example, in a recent case I worked on, a policy of \$2 million, for a male aged 47, cost approximately \$46,000 per annum. The “rider” to recover the amount of \$975,000 at the end of 15 years cost \$19,000 per annum. (The amount of \$975,000 is equal to the annual cost of both premiums of \$65,000 per annum times 15 years.)

If the individual has a corporation, the individual’s corporation should purchase the critical illness policy with the individual purchasing the recovery rider. Assuming that there is no event giving rise to the payout of the CI policy, at the end of 15 years, the individual will receive an amount equal to all of the premiums paid (both on the rider and the critical illness portion).

It appears that the full amount received by the individual will not be subject to tax. In effect, the individual will receive an amount equal to the premiums paid by the corporation under the CI policy without tax. This gives rise to a very healthy rate of return to the individual as the “extra amount” received by the individual (namely, an amount equal to the premiums paid by the corporation) avoids the usual tax on dividends resulting from corporation distributions. In the example given, the individual will save personal tax on a corporate distribution of \$690,000 (\$46,000 times 15 years). At a tax rate of 36% on dividends, this works out to a savings of approximately \$250,000 which should help pay for the policy (i.e. to recover the opportunity cost of laying out the money over 15 years and only recovering same at the end of 15 years).

IV. STOCK OPTION PLANS - THE BEST OF BOTH WORLDS

Stocks options are an excellent way for key employees to receive benefits (assuming that the value of a corporation's stock increases) as any such increases in value are usually only subject to 50% taxation. The problem, however, with most stock option plans, is that the corporation that issues the options does not receive any tax deductions for the options it issues.

Based on case law and the Canada Revenue Agency's pronouncements, if the employee (and not the employer) has the right under the plan to choose cash instead of shares, and if the employee chooses the cash option, the employee will still receive a benefit which is only 50% taxable when such employee exercises the options at a profit (assuming the conditions set out in paragraph 110(1)(d) ITA apply). Further, the employer would not be restricted in its deduction for the payout under paragraph 7(3)(b) ITA since no shares would have been sold or issued under the plan.

The Canada Revenue Agency has confirmed this interpretation in Income Tax Technical News No. 7 which was issued on February 21, 1996. Also, the recent case of *Imperial Canada Tobacco Limited vs. The Queen* [2007 TCC 636] deals with this issue (although, this case was slightly different as it involved a cash payment to compensate an employee for the surrender of a stock option).

V. MORE INSURANCE PLANNING

Assume that a corporation has \$1 million of surplus that is the result of active business income (i.e. not investment income). If this \$1 million is extracted from the company there will be a tax of approximately \$350,000 to the individual if the money is extracted in one year as a dividend. Alternately, if the money is withdrawn over a number of years, and assuming the individual does not have significant other income, this tax burden would be reduced. If the individual dies with the surplus in the company, the estate of the deceased can withdraw the money at capital gains rates for a net return of approximately \$760,000 (using the “pipeline” plan).

If the money is conservatively invested (money markets, bonds, etc.) and assuming that the individual is over the age of 50, a “back to back” annuity/insurance product could be extremely beneficial.

Under such a plan, the \$1 million in the company is used to purchase an annuity with no guaranteed term. To be subtracted from the annuity payouts (which are high because there is no guaranteed return of capital) are the taxes payable on the annuity (which are low as the bulk of the payout is capital) and the premiums for a new insurance policy in an amount equal to the lump sum cost of the annuity.

Usually, in such circumstances, the corporation will net, on an after tax basis, more than it would under a GIC or bond (even after paying the insurance premiums for a replacement policy). Typically, the yield is approximately 4% to 5% after-tax which equates to a pre-tax yield of 8% to 10%. Therefore, this is a good investment and the payors are generally as solvent as banks (Sun Life, Royal Bank Insurance, Manufacturers Life, etc.).

On the death of the individual, the company is worth nothing as the annuity will be worthless as it terminates on the death of the individual and the insurance policy will only have a value equal to its cash surrender value which will be nil (see section 70(5.3) of the *Income Tax Act*). Therefore, there will be no tax consequences to the individual on death. Since the \$1 million will then flow through into the holding company's tax-free capital dividend account, this amount can flow out of the company without tax resulting in a savings to the individual and/or his or her estate of between 24% (capital gains tax rate) to 36% (dividend tax rate). This increases the yield significantly (the increase in yield will depend on how long the annuitant lives).

There are a number of variations based on the same theme which basically exploits the "old" mortality tables used to establish the taxability of annuities and the "play" of avoiding tax on the distribution of the corporation's surplus by converting same into a tax-free dividend. You should also note the difference between "prescribed annuities" and "regular corporate annuities". Prescribed annuities are actually taxed at a lesser rate than normal corporate annuities and there are some plans that can be used to take advantage of this difference as well.