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COMMENT

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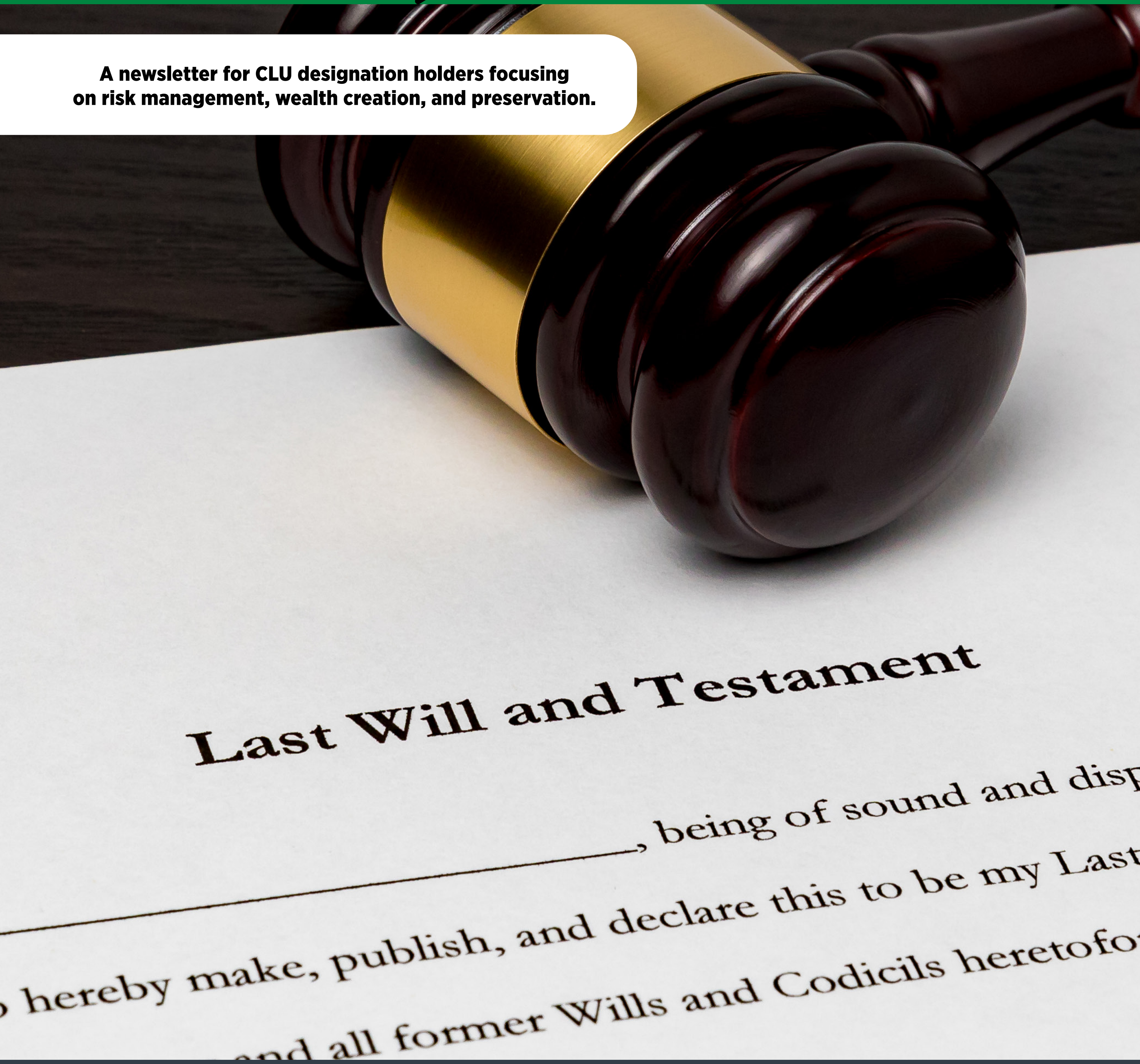

Non-Resident Beneficiaries of a Segregated Fund Contract

by Jon Hreljac

For a variety of reasons, segregated funds can be part of a solid investment and wealth transfer strategy. The various guarantees associated with a segregated fund contract (death, maturity, or income) can be very attractive. For others, the appeal is the ability to name a beneficiary directly on a non-registered contract for estate planning purposes. However, many clients and advisors are not aware of the unique opportunity segregated funds offer to transfer wealth to a non-resident beneficiary outside of Canada.

The value of naming a beneficiary can be significant. If you name a beneficiary, an insurance company is obligated, under the *Insurance Act*, to pay any death benefit proceeds to the named beneficiary on record.

Having the death benefit proceeds bypass the estate provides many advantages. It can avoid delays in settling the estate, including estate litigation. Often during this time, investments in an estate are frozen and exposed to the risks of the market (e.g., a market correction) and creditors. But if a beneficiary is named, the death benefit proceeds are usually paid within two weeks of receipt of proper documentation while also bypassing probate[1] and other estate administration fees.

Probate fees will vary by province. Other estate administration, accounting, and legal fees could be another 5% or more, depending on the complexity of the estate. Bypassing probate also preserves confidentiality as probate is a matter of public record; payments made by insurance companies are generally a private matter.[2] This can be beneficial to situations where the intention is to keep one's wishes undisclosed between family members.

Finally, many insurance companies offer a gradual inheritance strategy, also known as the "annuity settlement option," where the death benefit is used to purchase an annuity in lieu of a lump sum death benefit that a beneficiary would otherwise receive. This strategy is particularly useful in situations where the beneficiary is a spendthrift but the intention is to avoid the expense of setting up and maintaining a formal trust.

Typically, these advantages and planning opportunities are considered in the traditional sense when transferring wealth to beneficiaries who are residents in Canada. However, if an individual has a number of children who are the intended beneficiaries, it's possible that one or more of these beneficiaries could be a non-resident of Canada. And, as such, many clients are faced with the dilemma as to how to efficiently transfer wealth to beneficiaries who live abroad. When confronted with the many pitfalls an executor can face under these circumstances it may seem overwhelming. Segregated funds present a solution that can help remedy this problem.

The Issues

Under the *Income Tax Act*, non-resident beneficiaries are treated differently than resident beneficiaries. Non-resident beneficiaries present a different set of challenges to executors that carry potential for personal liability if not dealt with correctly. As well, decision making by executors when there are non-resident beneficiaries has significant potential to create issues between the resident and non-resident beneficiaries.

An estate with beneficiaries living outside of Canada could present challenges, as distributions of property to non-residents potentially involve a number of additional tax issues. For example, there is a requirement for the executor to withhold non-resident tax of 25% of the gross income distributed to non-residents of Canada, unless the beneficiary resides in a country where Canada has a tax treaty, in which case the withholding tax rate can be reduced.

To further complicate the issue, the deduction and remittance of withholding tax requires the executor to open a non-resident withholding tax account with the Canada Revenue Agency (CRA) and to issue an NR4 tax slip to the non-resident beneficiary reporting these amounts. The failure on the executor's part to properly execute on these matters can result in them being held personally liable.

If certain capital assets are distributed to the non-resident beneficiary, a capital gain may be realized by the non-resident beneficiary. As such, the estate should withhold and remit 25% of the deemed proceeds to the CRA until a Certificate of Compliance (Section 116 Clearance Certificate) has been issued, as the non-resident beneficiary is subject to Canadian tax on the gain of taxable Canadian property. If there is no inherent gain in the trust property that is distributed, there should be no tax liability. Despite this result, the CRA still takes the position that the beneficiary is required to give notice of the disposition to the CRA. Similarly, the executor can also be personally liable for tax payable by a non-resident beneficiary in respect of distributions of taxable Canadian property without having received the Section 116 Clearance Certificate.

Here's an example of how badly things can go wrong when distributing assets from an estate to a non-resident beneficiary. An executor was given "faulty" advice to mail a large amount of bank drafts to beneficiaries residing in the U.S. As these monies were not properly declared when entering the country this caught the attention of border officials who seized the money, saying the money was "deemed counterfeit."[3] Despite the fact that one of the intended beneficiaries was in desperate need of the money because of deteriorating health and mounting medical bills, it was held by the U.S. border officials for nearly a year before being released "upon further inspection" after finding the bank drafts to be legitimate.

Last Will and Testament
, being of sound and disposin
do hereby make, publish, and declare this to be my Last Will
evoking any and all former Wills and Codicils heretofore ma
ARTICLE ONE
Executor to pay out of the residue of my es
I further dire

With this in mind, an opportunity exists with segregated funds when naming a non-resident as a beneficiary of a segregated fund to ease the amount of work and risk an executor would otherwise face. Where the owner of a non-registered segregated fund contract is a Canadian resident, the tax liability on death will be included in their final Canadian tax return. For a segregated fund, the capital gain or loss will be reported to the owner on a T3 tax slip. In turn, the beneficiary, *in any country*, will receive the gross proceeds *directly*, as the death benefit bypasses the estate of the deceased and is paid to the beneficiary. There is no non-resident withholding tax withheld. However, if there is a delay from the date of death to the date the death proceeds are paid, there may be some interest paid to the beneficiary. The interest will be reported to the beneficiary on an NR4 tax slip, however, there is no requirement for non-resident withholding tax on this interest.

Additionally, when the beneficiary is a non-resident of Canada, it is still possible to accommodate the death benefit payment to the non-resident beneficiary in the form of an annuity via a gradual inheritance strategy (also known as the "annuity settlement option") despite the fact that in normal course, insurance companies typically do not sell to non-residents directly. When the owner and annuitant of the annuity is a non-resident, the non-resident taxation rules would apply and there would be withholding taxes on the periodic annuity payments reported on an NR4 tax slip.

When the beneficiary receives the funds, they will need to work with their tax advisor to consider any tax implications in their country of residence, for example, an inheritance tax, or taxation on any income or growth on their inheritance.

Advisors are encouraged to help identify this potential opportunity that exists with their clients. For clients with non-resident beneficiaries, positioning a "sleeve" of their portfolio as a wealth transfer strategy can help ensure a quick wealth transfer abroad while relieving the executor of many potential headaches while minimizing estate fees. ©

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[1] The probate process and fees do not apply in Quebec. There is a verification process for non-notarial wills but not for notarial wills.

[2] In Saskatchewan, jointly held property and insurance policies with a named beneficiary are included on the application for probate but do not flow through the estate and are not subject to probate fees.

[3] It is legal to transport any amount of currency or other monetary instruments into or out of the United States. However, if you transport, attempt to transport, or cause to be transported (including by mail or other means) currency or other monetary instruments in a combined amount exceeding US$10,000 (or its foreign equivalent) at one time from the United States to any foreign country or into the United States from any foreign country, you must file a FinCEN Form 105 ("Report of International Transportation of Currency or Monetary Instruments") with U.S. Customs and Border Protection.

Drilling Down on Bill C-208

by Kevin Wark

Bill C-208, an Act to amend section 84.1 of the *Income Tax Act* to provide an exception for intergenerational transfers of shares, has been on quite the roller-coaster ride. While the bill's bumpy journey is not quite over, there now appears to be greater clarity about its current and future status.

Section 84.1 is an anti-avoidance provision, originally intended to prevent the stripping of surplus from a corporation on a tax-free basis by using the lifetime capital gains exemption. A reduction in the paid-up capital of the shares received on the transaction (or substituted shares) and/or a deemed dividend can result depending on the transactions involved.

The deemed dividend rules in section 84.1 will generally apply where an individual shareholder (the taxpayer) disposes of shares in a Canadian-controlled private corporation to another corporation controlled by a person with whom the taxpayer does not deal at arm's length (for example, a spouse, sibling, or child). Other rules will apply where a family member acquires the shares directly from the business owner, and the capital gains exemption is claimed on the sale.

The following example illustrates the negative impact that section 84.1[1] can have on the transfer of shares in a private business:

> *Ms. Smith owns 100% of the common shares of XYZ Co., and those shares qualify for the lifetime capital gains exemption. Jane, her daughter, has been working in the business for a number of years and is interested in acquiring her mother's shares when her mother retires. The shares are independently valued at $1.2 million, with a nominal ACB and paid-up capital.*
>
> *Ms. Smith is subject to a 47% tax rate on dividends from XYZ Co. and a 26% tax rate on capital gains. Ms. Smith is entitled to claim a lifetime capital gains exemption in respect of $800,000 of capital gains on the disposition of the shares.*
>
> *Ms. Smith is approached by an arm's-length corporation ("ArmCo"), which is interested in purchasing all her shares for $1.2 million. Should Ms. Smith accept this offer, she would realize a capital gain of $400,000 after utilizing the lifetime capital gains exemption. The resulting tax liability would be $104,000, leaving her with after-tax proceeds for her retirement of just under $1.1 million.*
>
> *Ms. Smith advises Jane of the offer, and Jane indicates that she is prepared to match the terms. Jane plans to set up a corporation to purchase the shares in XYZ Co. as she's been told this would allow her to use the future profits of XYZ Co. to finance the buy-out on a more tax-efficient basis. However, after speaking with her accountant, she learns that using this structure will result in the application of section 84.1, with the result that Ms. Smith will be deemed to have received a taxable dividend of $1.2 million (rather than a capital gain). As a consequence, Ms. Smith will not be entitled to claim the lifetime capital gains exemption and will have a resulting tax liability of $564,000. By selling her shares to Jane, Ms. Smith's after-tax proceeds will be reduced by more than 40% from $1.1 million to $636,000.*
>
> *To avoid the application of section 84.1, Jane could directly purchase the shares from her mother. In this case, Ms. Smith's tax bill would be equal to what would arise on the sale of the shares to ArmCo. However, section 84.1 results in Jane not having "hard basis"*

for $800,000 of the purchase price for the shares (the amount of Ms. Smith's capital gains that are offset by the lifetime capital gains exemption). This means that although Jane has paid $1.2 million for the shares, she cannot implement steps to get a return of $800,000 of that investment tax free (unlike ArmCo, which will be able to do so).

If Jane needs to borrow the $1.2 million to pay for the shares of XYZ Co., XYZ Co. would need to distribute more than $1.9 million in non-eligible dividends to Jane to enable her to net $1.2 million after tax to repay the loan. This represents a 60% increase in cash flow requirements in relation to an arm's-length purchaser, since XYZ Co. could otherwise flow profits to a corporation controlled by ArmCo on a tax-free basis to repay the amount owing to Ms. Smith.

As demonstrated by the example, section 84.1 either penalizes Ms. Smith or Jane, as compared to an arm's-length sale, through the imposition of significantly higher taxes on Ms. Smith if the shares are sold to a corporation controlled by Jane, or significantly higher costs to Jane in financing the purchase where the shares are purchased directly.

The bill was supported by small business organizations and other stakeholders, including the Conference for Advanced Life Underwriting (CALU), and subsequently by a majority of members in the House of Commons and Senate on the basis that it would facilitate bona fide intergenerational business transfers by retiring business owners, supporting family ownership of small businesses and continuity of those businesses in local communities.

Bill C-208 Amendments to Section 84.1

After much debate and discussion, Bill C-208 received Royal Assent on June 29, 2021. This was a significant accomplishment given the opposition this bill faced from the federal government in both the House of Commons and the Senate. The opposition was based on Finance Canada's concerns that the bill could facilitate corporate surplus stripping arrangements, resulting in the loss of significant tax revenues.

Those supporting Bill C-208 (including CALU) recognized that while it was not perfect, the bill successfully addressed the existing unfair tax treatment caused by section 84.1, which penalized business owners who wished to transfer their business to children and grandchildren. Proponents of the bill noted that, despite promises to modify section 84.1, the federal government had failed to act in addressing these inequities. It was further suggested that to the extent there were concerns with Bill C-208, Finance Canada could make the appropriate legislative changes once the bill had been enacted.

Below are the various requirements in the bill that must be satisfied to qualify for the exemption from section 84.1, and certain concerns with the amendments that have been identified by Finance Canada and the tax advisory community.

a) Criteria to qualify for the exception

The new rules will deem the selling shareholder (the "taxpayer") and the purchaser corporation "to be dealing at arm's length" (and not subject to the anti-avoidance rules in section 84.1) in the following circumstances:

- **a.** the shares being sold (referred to as the "subject shares") are qualified small business corporation shares or shares of the capital stock of a family or fishing corporation;[2]
- **b.** the purchaser corporation is controlled by one or more children[3] or grandchildren of the taxpayer who are 18 years of age or older; and
- **c.** the purchaser corporation does not dispose of the subject shares within 60 months of their purchase.[4]

Discussion: Finance Canada officials have expressed several concerns with the broad nature of the exception to section 84.1. For example, the purchaser corporation is not required to control the subject corporation after the sale. Thus, it is possible for the taxpayer to directly (by retaining shares in the subject corporation) or indirectly control and profit from the business being sold, which arguably conflicts with the goal of facilitating the retirement of the business owner by passing the family business to the next generation. As well, there is no requirement that the children/grandchildren be engaged in the business being acquired.

The requirement that the purchaser corporation not dispose of the shares of the subject corporation within 60 months of their purchase may also be considered problematic by Finance Canada, as it does not restrict the children/grandchildren from selling shares in the purchaser corporation (which owns the subject shares) to non-arm's-length purchasers. It is also not clear what the effect would be if there was a partial disposition of the subject shares in the 60-month period.

b) Sale of subject shares by purchaser corporation within 60 months

As noted, the exception to section 84.1 is not available where the purchaser corporation disposes of shares in the subject corporation within 60 months from the date of purchase. In these circumstances, except where the disposition was "by reason of death,"[5] for the purposes of paragraph 84.1(2)(e) the following rules will apply:

- **a.** the exception to section 84.1 contained in paragraph 84.1(2)(e) is deemed to have never applied;
- **b.** the taxpayer is deemed, for purposes of section 84.1, to have disposed of the subject shares to the person who acquired them from the purchaser corporation; and
- **c.** the 60-month period applicable to the sale under b) above is deemed to have begun when the taxpayer disposed of the subject shares to the purchaser corporation.[6]

Discussion: Both the underlying intent of this provision and related tax implications are unclear. Arguably, if the shares of the subject corporation are sold back to the taxpayer (or persons related to the taxpayer) within the 60-month period, it is possible that the original transaction was not entered into for bona fide purposes, and section 84.1 should have applied to the original sale. However, if the sale of the shares is to an arm's-length third party, this should not trigger adverse tax consequences to the taxpayer, as section 84.1 would not have applied had the taxpayer originally sold those shares to the new purchaser.[7] Also, as previously noted, this provision does not apply where the shares in the purchaser corporation are sold. Greater drafting clarity (or an interpretation of these provisions by the Canada Revenue Agency (CRA) would be helpful to ensure that the taxpayer and other parties to the sale transaction understand the tax impact of a future sale within the 60-month period.

c) Reduction in capital gains exemption

An additional provision appears to be intended to reduce the taxpayer's access to the lifetime capital gains exemption (presumably only for the purpose of a sale transaction that falls under the new exemption to section 84.1) where the subject corporation has taxable capital employed in Canada exceeding $10 million.[8]

Discussion: There is a technical drafting issue in relation to the interaction of this provision with other sections of the Act.[9] It is also important to note that while a taxpayer may lose the ability to claim the lifetime capital gains exemption where the subject corporation's taxable capital employed in Canada exceeds $10 million (assuming the provision is appropriately modified), any gain arising on the sale of those shares could continue to be treated as a capital gain, rather than being deemed to be a taxable dividend, by virtue of paragraph 84.1(2)(e).

d) Sale reporting requirements

The new legislation requires the taxpayer to provide the CRA with an independent assessment of the fair market value of the subject shares, as well as an affidavit signed by the taxpayer and by a third party attesting to the disposal of the shares, where the taxpayer is relying on the exemption to section 84.1.

Discussion: There are several interpretative and compliance-related issues with this requirement. For example, does the party making the independent assessment need to be an accredited valuator or would an assessment by the taxpayer's accountant be sufficient? What type of valuation information, if any, needs to be provided to back up the independent assessment? Who can be a "third party" for purposes of the affidavit? When does the assessment and affidavit need to be provided to the minister and how? What are the implications if a taxpayer does not provide the independent assessment or affidavit (or it is deficient in any respect)?

As is evident from the above discussion, while Bill C-208 deals with the main concern of tax inequities under section 84.1 that arise on the sale of shares in a private corporation to children and grandchildren, there is a great deal of ambiguity for business owners in terms of how the "anti-avoidance" rules apply in certain circumstances. In turn, the bill appears to open the door to certain transactions that would permit business owners to benefit from capital gains treatment while still retaining a significant interest in the business.

Implications for Small Business Owners and Their Advisors

Bill C-208 took effect as of June 29, 2021 (Royal Assent), and applies to business transfers taking place on or after that date. A Finance Canada press release has confirmed that the federal government plans to bring forward amendments to the *Income Tax Act* that would "honour" the spirit of Bill C-208 while safeguarding against any unintended tax avoidance loopholes that may have been created by the bill. As well, Finance Canada has stated that future amendments are not intended to be retroactive in effect. This provides additional comfort to business owners who plan to rely on Bill C-208 in transferring their business to children and grandchildren.

However, business owners still need to be concerned with the lack of clarity in the new legislation, and in particular the negative tax impact that can arise from the subsequent sale of shares in the 60-month period. There is also significant uncertainty for business owners contemplating the sale of their business in the future, as it is unclear how the rules will be further amended to prevent surplus stripping, and when such rules will become effective.

Finally, the result of the fall federal election could possibly result in totally different government dynamics. Therefore, it's even more important for business owners to consult with their professional tax advisors before entering into any business transfer arrangements with family members. ©

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[1] As it applied prior to the enactment of Bill C-208.

[2] The definition of these terms can be found in subsection 110.6(1) of the Income Tax Act (Canada) *(the "Act"). Note that there is no requirement that the taxpayer still have access to the lifetime capital gains exemption for this condition to be met.*

[3] Refer to the extended definition of child in subsection 252(1) of the Act, which includes a spouse or common-law partner of a child.

[4] New paragraph 84.1(2)(e) of the Act.

[5] Presumably, this is a reference to the death of the child or grandchild who controls the purchasing corporation, but this is not clear. Curiously, only paragraph 84.1(2.3)(a) is impacted where the subject shares are disposed "by reason of death," not the condition in paragraph 84.1(2)(e) that the subject shares not be disposed within 60 months of their purchase. It is assumed that the intention was to remove the 60-month hold condition in paragraph 84.1(2)(e) where the subject shares are disposed by reason of death; however, as currently worded, if the subject shares are sold by reason of death within the 60-month hold period, the conditions in the paragraph 84.1(2)(e) exception cannot be met.

[6] New paragraph 84.1(2.3)(a).

[7] This may in fact be the intent of subparagraph 84.1(2.3)(a)(ii) described in paragraph b) above.

[8] The exemption will be fully lost once the subject corporation's taxable capital in Canada reaches $15 million.

[9] An amendment to the Act is required to ensure that this provision applies for purposes of determining the amount that can be claimed under the lifetime capital gains exception in subsection 110.6(2) or (2.1).

COMMENT is an informative newsletter targeted to the unique niche that CLU advisors occupy in the financial services industry, with a focus on risk management, wealth creation and preservation, estate planning, and wealth transfer. COMMENT has been an integral part of the CLU environment since 1967.

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