The Institute™
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COMMENT

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## THE UNIQUE NATURE OF A POLICY LOAN

A policy loan is a uniquely defined transaction that can only involve a life insurance policy. The *Income Tax Act* (ITA) clearly sets out the consequences of a policy loan and its eventual repayment.

The taxation of a policy loan under a life insurance contract was the subject of a recent Tax Court of Canada decision where the taxpayer challenged the CRA's position that the loan was a taxable event. The facts of the case were as follows:

- In both 1977 and 1982, Mr. Neszt purchased a life insurance policy on his own life.
- In 2015, Mr. Neszt took out policy loans under each of these two life insurance policies.
- The insurance company issued T5 statements to Mr. Neszt in respect of the two loans on each of his life insurance policies. The T5 amounts resulted in total income of $26,360.

The taxpayer opted not to include the $26,360 amount in his income and the CRA issued a reassessment that included the amount as 2015 income. The taxpayer challenged the reassessment in the Tax Court of Canada on the basis that it was his opinion that a personal loan should not be a taxable event.

The judge noted that policy loans are governed by specific provisions of the ITA.

- A policy loan is defined as a disposition of an interest in a life insurance policy.
- The gain is the amount of the loan in excess of the adjusted cost basis of the life insurance policy.
- The purpose of these rules is to ensure that a policy holder is taxable on values received from the policy in excess of the adjusted cost basis of the policy.

The judge reaffirmed the CRA's assessment. He confirmed that the T5 statements issued by the life insurance company were correct.

As noted by the judge, a policy loan is defined as a disposition of an interest in a life insurance contract. A gain is recognized if the proceeds of the disposition, at the time of the policy loan, are in excess of the adjusted cost basis of the policy.

It is worth noting the fact that the policy holder is entitled to a deduction when a policy loan is repaid. The deduction is equal to the lesser of the amount repaid and the gain previously recognized in income.

The ITA contains many specialized provisions that can confound the principles of normal language. As such, it is important for individuals to understand the tax consequences that may arise when undertaking even a simple financial transaction so as to minimize unexpected tax consequences.

## BE CAUTIOUS WHEN STRUCTURING A CHARITABLE GIFT

Utilizing a life insurance policy for planned giving generally involves the donation of the life insurance policy itself or the donation of the death benefit. How the gift is structured will depend on the facts of the situation and the objectives of the client.

When a life insurance policy is donated to a charity, ownership is transferred to the charity. The charity can issue a charitable gift receipt for the fair market value (FMV) of the policy at the time of transfer.

If the donee agrees to pay the future premiums due under the policy, then the charity can issue a charitable gift receipt as any subsequent premium payments are made. The donee must recognize a disposition of the life insurance contract for proceeds equal to the greater of the policy's cash surrender value (CSV) and the policy's adjusted cost basis (ACB). If the deemed proceeds are greater than the policy's ACB, the individual must recognize a policy gain.

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When the death benefit of a life insurance policy is donated, the charity can issue a charitable gift receipt for the value of the funds received at the time of the life insured's death. In these situations, the policy's ownership remains with the individual and the charity is the named beneficiary under the policy. The charity will eventually receive the proceeds of the life insurance policy through their contractual right as a beneficiary under the insurance policy. If the charity receives the funds during the time the deceased's estate qualifies as a graduated rate estate, the executor may claim a charitable tax credit on the terminal return, the return for the year prior to death or any return of the estate (subject to limitations on carryforward periods).

How the title of an insurance policy is transferred to a charity was the subject of a Canada Revenue Agency's (CRA) technical interpretation in which the CRA responded to a question raised at a tax conference. The situation and question were as follows:

- An individual owns a life insurance policy on the life of his daughter.
- The individual wants to transfer title of the policy to the family's private foundation upon his death.
- Assume at the time of the policy owner's death the CSV is $200,000, the ACB is $50,000 and the FMV is $500,000.
- What are the results if the individual instructs his executor to transfer title from the estate to the foundation?
- What are the results if the individual names the charity as the contingent owner of the policy?

The CRA responded as follows:
To the extent that ownership of the policy is transferred by the executor from the estate to the charity, a charitable gift would be realized by the estate equal to the FMV of the policy, $500,000. The estate would also realize a disposition of the policy for deemed proceeds equal to the greater of CSV and ACB, $200,000. The disposition realized by the estate would result in a policy gain of $150,000 (deemed proceeds of $200,000 in excess of an ACB of $50,000).

To the extent the donation is affected by the charity becoming the owner of the policy because of its contractual right as the contingent owner, then no charitable gift would be realized by the estate. The estate would also realize a disposition of the policy for deemed proceeds equal to the greater of CSV and ACB, $200,000. The disposition realized by the estate would result in a policy gain of $150,000 (deemed proceeds of $200,000 in excess of an ACB of $50,000).

The CRA's response indicates that a gift does not occur under the contingent owner option because the charity exercised a contractual right to become the owner of the insurance policy.

This is a reasonable outcome because there is a specific deeming rule in the ITA that deems a gift to occur when the charity receives the life insurance benefit as a contractual right of the policy's beneficiary. There is currently no rule that recognizes the transfer of title of an insurance policy by right of contingent owner.

Charitable gift planning can be complicated because of the facts of the situation or the objectives of the client, so it is important that the final plan does not result in any surprises.

## ADMINISTRATIVE LENIENCY IS AT CRA'S DISCRETION

The Canada Revenue Agency (CRA) publishes an administrative policy that permits individuals to not include as income earned, commission earned on a sale to themselves. If the commission income is reported to an individual, he or she may claim a deduction for the commission earned. Of significance is the fact this policy does not arise from a specific provision in the *Income Tax Act* (ITA), but rather is an administrative policy of the CRA.
This policy was the centre of a recent Tax Court of Canada case. The facts of the case were as follows:

- Mr. Ghumman was an incorporated life insurance broker operating through Ghumman Financial Planning Inc (GFP).

- GFP was entitled to receive all the commissions earned and Mr. Ghumman was paid a salary from GFP.
- In 2014 Mr. Ghumman purchased a $1,000,000 life insurance policy on himself.
- While no details of the policy were provided, GFP received $57,261 representing first year commission and bonus in respect of the policy.
- GFP paid Mr. Ghumman a salary of $111,617 in 2014.
- Relying on CRA's administrative policy, Mr. Ghumman deducted $57,261 from his total salary when filing his 2014 personal income tax return.
- The CRA reassessed Mr. Ghumman, disallowing the deduction for the commission earned on his own policy noting on the assessment that the commissions were "significant."
- While Mr. Ghumman requested clarity around what the CRA viewed as significant, this was not provided.

The judge began by noting that Mr. Ghumman was an employee of GFP, and employees have a limited range of amounts that can be deducted from employment income. There is no provision in the ITA that permits a deduction from employment income for commissions earned on the sale of an item to the employee.

The judge concluded that the taxpayer cannot expect the Court to require the CRA to comply with its administrative policy in a situation where that policy is not consistent with the ITA. The judge concluded that he could not change the assessment because he is bound by the legislation as set out in the ITA. As such, he cannot force the CRA to apply their administrative policy. This led the judge to conclude that because there was no provision under which to permit the deduction, the court had to affirm the CRA's assessing position that denied the deduction of $57,261 on Mr. Ghummn's 2014 personal tax return.

The most recent version of the CRA's administrative position is set in a folio that provides employers with guidance related taxable benefits and allowances. The folio explains that "commissions that sales employees receive on merchandise they buy for personal use are not a taxable benefit." The policy sets out that in situations where "life insurance salespeople acquire life insurance policies, the commissions they receive are not taxable as long as they own the policies and have to make the required premium payments. This only applies where the income received is not significant and the insurance policy has no investment component or business use." A separate note explains that the CRA's policy does not apply to discounts on services.

The CRA's position includes the statement, "this only applies where the income received is not significant." The challenge with this statement is its uncertainty, as the CRA is silent on what amount of commissions, in their view, would be considered significant. As shown in the Ghumman case, the courts have no influence on challenges brought forward by a taxpayer against the denial of the benefit arising from the CRA's administrative leniency.

The case serves as a reminder that the CRA's administrative policy is their policy and they can withhold leniency depending on the facts of the situation.

## GRE DESIGNATION AND NON-RESIDENTS

The concept of a graduated rate estate (GRE) is reasonably new so the Canada Revenue Agency (CRA) continues to answer questions related to the qualifying criteria and operation of a GRE. Two recent queries answered by the CRA relate to estates and non-resident individuals. To begin with, a GRE is a term applied to the estate of an individual when the estate meets specific criteria. In general terms, an estate can qualify as a GRE for the first 36 months immediately following the death of the individual. The estate must be a testamentary trust and the executor must designate the estate as a GRE when filing the estate's first income tax return. An estate benefits from being designated as a GRE because income of the GRE is taxed using the progressive tax rate structure whereby the estate will pay a marginally higher percentage of income tax as its income increases. Without GRE status, the estate would be subject to tax on its income at the top tax rate, without the benefit of marginal rates.

When filing for GRE status, the executor is typically required to include the deceased individual's social insurance number (SIN). There is a provision, however, that addresses the issue if an individual does not have a SIN when making the GRE designation. This may be the case if, for example, the deceased had never worked or resided in Canada.

In the first scenario addressed by the CRA, an individual is a US citizen and resident of the US throughout their lifetime but owns Canadian real estate at the time of their death. The estate executor was resident in the US and all decisions related to the estate took place in the US resulting in the estate being factually resident in the US. The estate would have an income tax reporting requirement associated with the deemed disposition of the property at death and subsequently from the gain on the disposition of the property anticipated to be realized in the estate.

The CRA confirmed that there is nothing in the definition of a GRE that requires the estate to be resident in Canada nor that the deceased individual must have resided in Canada before their death. As such, in this scenario, the estate could apply to be designated as a GRE, assuming it meets the qualifying criteria. Once designated as a GRE, the estate will benefit from the progressive tax rates rather than be subject to tax at the top marginal rate. If the deceased individual in this scenario does not have a SIN number, this will not preclude the estate from applying for GRE status. While a SIN number is one of the requirements, there is also verbiage in the legislation that addresses the situation when the individual did not have an assigned SIN number before their death. The legislation allows for "such other information as is acceptable to the Minister." In this case, the CRA has confirmed that the estate could apply for a temporary tax number or an individual tax number. An individual tax number can be obtained by completing form T1261 (The Application for a Canada Revenue Agency Individual Tax Number (ITN) for Non-Residents).

A second query to the CRA related to the scenario where a non-resident individual passes away and a non-resident trustee is managing the deceased's estate. Subsequently, the non-resident trustee resigns, and a new trustee is appointed. The new trustee lives in Canada and the management of the estate results in the estate becoming factually resident in Canada.

The CRA confirmed that provided the estate meets all the qualifying requirements for GRE status, the executor can apply to designate the estate as a GRE in the first income tax return that the estate is required to file in Canada.

The example on which the CRA commented involved a non-resident individual who dies in 2016. The estate of the deceased individual meets all the criteria to be non-resident until 2018. In 2018, when a new executor is appointed and the estate becomes resident in Canada, the estate is eligible to designate itself to be a GRE when filing its first income tax return related to 2018. The months remaining during which the estate may qualify as a GRE will reflect the fact that the clock for the 36 months of GRE status starts from the individual's date of death.

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