



# COMMENT

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## INSURED REDEMPTION STRATEGY - REVISITED

Tax planning strategies are constantly changing to take into account the changes made to the Income Tax Act. Following an old strategy in a new environment may lead to unexpected results. For example, the old “25% solution” for share redemptions has changed dramatically during 2000 with the reduction in the capital gains inclusion rate.

Buying life insurance to fund the payment of income taxes that arise upon the death of an individual, or the second death in a couple, is a common planning strategy. If the resulting income tax liability relates to shares of a private corporation, careful planning may lower the overall tax liability. In this way, life insurance can minimize the income tax liability at the same time as meeting cash flow demands.

Under this strategy, the company will own insurance on the life of the share-

holder, pay the premiums, and receive the insurance proceeds. Upon the shareholder’s death, the company will redeem some or all of the shares owned by the deceased (usually as set out in the terms of a binding buy-sell agreement). The redemption can be funded with some combination of the life insurance proceeds, liquid assets, new debt instruments, or new shares. The company will elect that a portion of the resulting deemed dividend be paid from the company’s capital dividend account created upon the receipt of the life insurance proceeds. The redemption will also trigger a capital loss in the estate, which can be carried back (subject to some restrictions) to the deceased’s terminal return to reduce the deemed capital gain triggered by the death.

### Example

#### Terminal Tax Return

Proceeds of deemed disposition	2,000,000
Less ACB and/or CGE	Nominal
Capital gain	2,000,000
Taxable capital gain (50%)	1,000,000
<b>Estimated taxes (46%)</b>	<b>460,000</b>

	<b>Old “25% Solution” Strategy</b>	<b>Newer Planning Strategy</b>
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#### Estate Tax Return

Proceeds of redemption	2,000,000	920,000
Funded with insurance	460,000	460,000
Funded with promissory note	1,540,000	460,000
Proceeds of redemption	2,000,000	920,000

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Less: paid up capital	Nominal	Nominal
Deemed dividend	2,000,000	920,000
Elected as a capital dividend	460,000	460,000
Remainder is a taxable dividend	1,540,000	460,000
Estimated taxes (31%)	477,400	142,600
Proceeds of redemption	2,000,000	920,000
Less: deemed dividend	2,000,000	920,000
Deemed proceeds of disposition	Nominal	Nominal
Less: adjusted cost base	2,000,000	920,000
Capital loss	2,000,000	920,000
Reduction under the stop-loss rules	None	None
Carried back to terminal return	2,000,000	920,000
<u>Revised Terminal Tax Return</u>		
Capital gain as filed	2,000,000	2,000,000
Capital loss from estate	2,000,000	920,000
Net	Zero	1,080,000
Taxable capital gain	Zero	540,000
Estimated taxes (46%)	Zero	248,400
<b><u>Total taxes paid</u></b>	<b><u>477,400</u></b>	<b><u>391,000</u></b>
<b><u>Position of the estate:</u></b>		
Net cash received (life insurance proceeds minus total taxes paid)	(17,400)	69,000
Promissory note from the corporation	1,540,000	460,000
Promissory note from remaining shareholders	Zero	1,080,000

While the above example is based on a great number of assumptions, it does prove that following old advice may increase an income tax liability. The old “25% solution” plan of 100% redemption should be revisited. Using the “newer planning strategy” outlined above, the redemption was limited to that amount that would allow the maximum amount of capital dividends, minimize the remaining taxable dividends (which are taxed at about 30%) and leave the greatest amount of capital gains (now taxed at less than 25%). The deceased’s remaining shares were then sold to the other shareholders (there would be no gain on this disposition, since the shares have an ACB of \$1,080,000 to the estate). In both cases, the estate is owed a total of

\$1,540,000, but under the new strategy, it ends up with \$86,400 extra cash.

Planning for the death of a shareholder involves numerous factors, and structuring and implementing any strategy is complex. First and foremost, the objectives of the shareholders and their beneficiaries must be met; then all the details must be carefully set out in a shareholders’ agreement with the help of informed professional advisors. Estate planning strategies are constantly changing because of the constantly changing tax and legal environment. For these reasons, it is crucial to equip yourself with competent, up-to-date advisors.

*I/R 2500.07*

## TAX-FREE ROLLOVER OF INSURANCE TO A CHILD

**P**lanning for your family’s future? A life insurance policy can be a unique and valuable gift for your child or grandchild.

In general, when the transfer of ownership of a life insurance policy takes place, there is a disposition of the policy for income tax purposes. If the proceeds of

the disposition (typically the cash surrender value of the policy) are greater than the adjusted cost basis (ACB) of the policy, a policy gain will occur. The amount of the policy gain is fully taxable as income to the transferor.

In certain situations, however, the Income Tax Act allows for a life insurance policy to be transferred for proceeds of disposition equal to the policy's ACB. This effectively allows for a tax-free "rollover" of the policy between parties. To qualify for the tax-free rollover of a policy from a parent or grandparent to a child or grandchild, the following conditions must be met:

- A child or grandchild of the policy-owner must be the life insured under the policy.
- The policy must be transferred to the policy-owner's child or grandchild for no consideration. (The recipient child does not have to be the same person as the child whose life is insured. Therefore, a tax-free rollover would occur where a grandfather, who owns a policy on the life of his son, transfers the policy to his granddaughter.)
- Only one life can be insured under the policy. (The Canada Customs and Revenue Agency (CCRA) has confirmed in a technical interpretation that the child must be the only life insured under the policy for the rollover to apply.)

Thus, in the course of planning for the future, a parent or grandparent can purchase a policy on the life of a child or grand-

child (assuming underwriting qualifications have been met). To continue the example above, a policy on the life of the son could provide funds for the upbringing of the granddaughter, should her father die while she is young. And if he survives, that valuable policy can be transferred to the grandchild on a tax-free basis at some point in the future. The child could then use the value in the policy, for example, to pay university costs or make a down payment on a home.

If the recipient child realizes income from a transferred policy before attaining age 18, such income is subject to the attribution rules. This might arise if the child takes a partial withdrawal or obtains a policy loan. In that case, any taxable amount will be included in the income of the transferor. If the child is 18 years of age or older when the income is realized, however, the attribution rules will not apply and any policy gain will be taxable in that child's hands.

Whenever the owner of a life insurance policy contemplates transferring ownership to another party, it is important to ensure that the parties involved understand the tax consequences of the transfer.

*I/R 4200.00*

## RESEARCHING ON THE INTERNET

Daily media coverage keeps the Internet in the forefront of the regular barrage of information communicated to us. It is without hesitation that we acknowledge that the Internet has become one of the greatest research vehicles ever, and it is widely available to just about anyone. Its exponential growth makes it a force to be understood rather than ignored or feared. As a tool, the Internet increases ease-of-access to information, but it becomes increasingly important that this information not be used in isolation but rather with a sense of awareness.

For consumers of financial services, when used well, the Internet can provide quick access to information on a large range of products, services and regulations. There is no single source of website listings that one can rely on, but rather each individual seems to develop his or her own reference list. In addition, one may "search the web" for a particular topic.

No matter how one uses the web, reliability of information is paramount. When using the Internet, clarify the source of the site and, if necessary, identify the site's author to assess credibility. There are no

common standards across the Internet that offer the viewer an assurance that the information being used is reliable – this is clearly “buyer beware.” Cross-referencing a site with other independent sources on the same topic is helpful to increase reliability. If possible, opt for information posted on official sites, where such sites exist, rather than information on private sites. And always check to make sure the information is timely – once-correct but outdated information can be as dangerous

as incorrect material. And remember that you can’t always rely on the date the *site* was last updated – this is no guarantee that the specific information sought was also updated on that date.

To assist our readers, we have developed a short list of official websites that may be useful sources of data or starting points for your search. In no way is this list a comprehensive summary – this would be impossible given the phenomenal growth of this communication vehicle.

#### **Federal Government Websites**

[www.canada.gc.ca](http://www.canada.gc.ca) - **Government of Canada**

- Information about Canada, programs and services, forms, publications and a directory to government departments and ministries

[www.ccr-aadrc.gc.ca](http://www.ccr-aadrc.gc.ca) - **Canada Customs and Revenue Agency**  
(formerly Revenue Canada)

- Access to forms and publications such as IT bulletins and income tax guides

[www.hrdc-drhc.gc.ca](http://www.hrdc-drhc.gc.ca) - **Human Resources Development Canada**

- Information about government social programs such as Canada Pension Plan, Old Age Security, and Employment Insurance, along with forms and publications

[www.fin.gc.ca](http://www.fin.gc.ca) - **Finance Canada**

- Access to Department of Finance releases including federal budgets and draft legislation along with regular updates posted in the “What’s New” section

[www.statcan.ca](http://www.statcan.ca) - **Statistics Canada**

- Access to the latest statistics and ability to order products and services online

#### **Provincial Government Websites**

[www.gov.ab.ca](http://www.gov.ab.ca) - **Alberta**

[www.gov.mb.ca](http://www.gov.mb.ca) - **Manitoba**

[www.gov.nf.ca](http://www.gov.nf.ca) - **Newfoundland**

[www.gov.ns.ca](http://www.gov.ns.ca) - **Nova Scotia**

[www.gov.on.ca](http://www.gov.on.ca) - **Ontario**

[www.gov.qc.ca](http://www.gov.qc.ca) - **Quebec**

[www.gov.yk.ca](http://www.gov.yk.ca) - **Yukon**

[www.gov.bc.ca](http://www.gov.bc.ca) - **British Columbia**

[www.gov.nb.ca](http://www.gov.nb.ca) - **New Brunswick**

[www.gov.nt.ca](http://www.gov.nt.ca) - **Northwest Territories**

[www.gov.nu.ca](http://www.gov.nu.ca) - **Nunavut**

[www.gov.pe.ca](http://www.gov.pe.ca) - **Prince Edward Island**

[www.gov.sk.ca](http://www.gov.sk.ca) - **Saskatchewan**

#### **CAIFA**

And don’t forget CAIFA’s website at [www.caifa.com](http://www.caifa.com), where you will find lots of information and links to other valuable sites.

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