



COMMENT

NUMBER 208 – JULY/AUGUST 2001

CAN YOU WEAR TWO HATS?

Within the Income Tax Act, several provisions deny or postpone the realization of a loss under certain circumstances. One such provision is the “affiliated stop loss rule.” This rule applies to a loss realized by a taxpayer on the disposition to a corporation of that corporation’s own shares (generally by redemption or retraction), where immediately after the disposition the taxpayer and the corporation are affiliated.

In those circumstances, the loss is deemed to be nil, and an amount equal to the loss (as otherwise calculated) must be added to the adjusted cost base of the remaining shares of the corporation held by the taxpayer. Thus, the loss is in essence deferred until the other shares are disposed of. The logic of the rule is to prevent an artificial loss from being triggered and sheltering tax otherwise payable. By adding the denied loss to the adjusted cost base of the other shares, the taxpayer does not lose a tax attribute but rather the tax value is deferred.

The rules defining “affiliation” can be quite complex. One part of the definition deems a corporation and the person controlling the corporation to be affiliated. (Note that the definition of “control” adds its own complexities.)

A critical area that warrants close observation of the affiliated stop loss rule is the estate planning strategy that calls for a redemption of shares upon the death of a shareholder. One of the objectives of such a redemption is the creation of a capital loss in the estate; that loss can be carried back to the terminal return to reduce the income tax liability that arises on the deemed disposition of the shares at death.

Examples of post-disposition control include the following:

1. The estate holds enough shares to control the company immediately after the redemption. This could result from a partial redemption of voting shares, where after the redemption the estate still holds enough votes to control the company. Alternatively, this could arise if the estate holds several classes of shares and the redemption takes place in the wrong order, so that the estate still holds voting control after one or more of the redemptions.
2. The estate holds debt that could be deemed to control the company after the redemption. This may occur if a full redemption of shares is funded by debt issued from the company to the estate.

3. The individual who controls the estate (i.e., the executor) also controls the company in his or her personal capacity after the redemption of shares from the estate.

The issue of executor control has been a hot topic for many tax practitioners over the years, because the Canada Customs and Revenue Agency (“CCRA”) has changed its position several times. One of the chief areas of concern is whether the estate controls the company after the redemption because the executor in his or her own personal capacity controls the company. In such a situation, the resulting loss could be deemed to be nil. Such a situation gives rise to the “two hats” issue

— can the executor have two separate and distinct roles, executor and his or her own personal role?

In a recent response to a taxpayer query, the CCRA confirmed that the estate does not control a company simply by reason of the executor’s control in a personal capacity.

Careful estate planning (and careful implementation of the plan) can ensure that a redemption does not fall into the affiliated stop loss rules. Even after this CCRA technical interpretation, it may be prudent to ensure that the business does not succeed to the executor by naming a third party as the executor in order to avoid the potential issue.

I/R 2500.07

SPLITTING THE CAPITAL GAINS EXEMPTION

Many tax plans begin with a noble purpose — to lower the income tax liability incurred by a taxpayer.

One common tax plan is a full or partial estate freeze where some common shares are placed in a trust on behalf of the business owner’s children. When the shares of the company are eventually sold, the gain realized by the trust will be allocated to the beneficiaries. If the shares are qualifying shares of a small business corporation, the beneficiaries will each be able to shelter the first \$500,000 of capital gain from income tax by claiming the capital gains exemption.

One issue that arises in this plan is the imposition of the alternative minimum tax (“AMT”). If an individual realizes a capital gain of \$500,000, the related income tax liability could be eliminated by claiming the capital gains exemption. However, for the purposes of calculating the AMT, 60 per cent of the non-taxable portion of a capital gain is added back to taxable income otherwise reported (in this case, 60 per cent of \$250,000, or \$150,000, is added to the AMT base). Although the capital

gains exemption claimed for regular tax purposes is also allowed for AMT purposes, the AMT liability would still be about \$16,500.

The minimum tax is refundable, but not until the regular tax exceeds the AMT in a year. Considering the fact that a minor seldom has a great deal of personal income, it may take a long time to effect the refund of the refundable tax. In addition, the AMT carryforward expires after seven years. Note also that the AMT is not refunded against the new “kiddie” tax on split income.

The implementation of any tax plan has both advantages and disadvantages. Your advisor will identify the issues so that you understand all of the advantages and all of the risks before you undertake a plan. Also remember that planning may need to be changed to keep pace with changes in the tax legislation, so it is wise to review your plans with your advisor on a regular basis.

I/R 2500.05

TRANSFERRING THE INTEREST IN A LIFE INSURANCE POLICY

Sometimes a life insurance policy has to be transferred between a shareholder and his or her corporation. When this occurs, several issues must be observed. For example, where the transferee is a shareholder of the company, different rules and valuations apply to the calculation of the policy gain in the hands of the transferor, and the calculation of the taxable benefit to the transferee.

Policy gain: To analyze the consequences of a policy disposition, consider the following two sets of facts for discussion purposes:

	Situation A	Situation B
Adjusted cost basis	\$10,000	\$20,000
Cash surrender value	\$15,000	\$ 5,000

The Income Tax Act deems a non-arm's-length transfer to take place at the policy's cash surrender value, regardless of the consideration paid. In situation A, the original owner would be deemed to have received proceeds of the disposition equal to the policy's cash surrender value, triggering an income gain of \$5,000 (excess of cash surrender value over adjusted cost basis). In situation B, there would be no income tax effect (i.e., no income inclusion and no ability to claim a loss).

Note that the Income Tax Act deems the new owner to have acquired the life insurance policy at a cost equal to the policy's cash surrender value (i.e., the deemed proceeds of the disposition noted above).

Shareholder benefit: The shareholder (and employee) benefit rules must also be considered when contemplating the transfer of a corporate-owned life insurance policy. One might expect that the shareholder would realize a taxable benefit equal to the value of the policy as determined for the purposes of calculating the policy gain. However, the Canada Customs and Revenue Agency ("CCRA") has repeatedly indicated that if the shareholder receives an asset from the corporation at less than the asset's *fair market value*, a benefit has been realized and must be recognized. In arriving at fair market value of a life insurance policy, the CCRA considers a number of factors in addition to the cash surrender value, including the loan value, face amount, state of health, life expectancy, conversion privileges, term riders, double indemnity provisions, replacement value, etc. To extend the example above, then:

	Situation A	Situation B
Fair Market Value	\$23,000	\$17,000

In situation A, the shareholder would realize a taxable benefit of \$23,000, and in situation B, the benefit is \$17,000. If the shareholder paid cash or other consideration to the company for the policy, the taxable benefit would be reduced accordingly.

A question arises as to whether the shareholder's adjusted cost basis of the policy will be revised to reflect the amount of the taxable benefit reported in income (remember that the adjusted cost basis is deemed to be equal to the cash surrender value as explained above). There is no provision in the Income Tax Act that directly

allows an appropriate adjustment to the adjusted cost basis; however, the CCRA will allow an adjustment equal to the difference between the policy's fair market and cash surrender values where this gives an "equitable result."

It should be noted that a company transferring a life insurance policy to its employee would generate similar treatment. The employee would recognize a taxable benefit to the extent the fair

market value was in excess of the consideration paid by the employee. Note that the amount of the benefit, as recorded on the employee's T4, would normally be deductible to the employer. This is contrary to a shareholder benefit, which is non-deductible.

I/R 5200.06

**Contributors to this issue of Comment:
James W. Kraft, CA, CFP, CLU, CH.F.C.**

This commentary is published by the Canadian Association of Insurance and Financial Advisors (CAIFA) in consultation with an editorial board comprised of recognized authorities in the fields of law, life insurance and estate administration.

The Canadian Association of Insurance and Financial Advisors (CAIFA) is a voluntary, not-for-profit professional association whose members, gathered in 51 chapters, are represented in most major cities and towns across Canada.

The articles in Comment are not intended to provide legal, accounting or other advice in individual circumstances. Seek professional assistance before acting upon information included in this publication.

© Registered trade-mark of Canadian Association of Insurance and Financial Advisors.

**Published by: Canadian Association of Insurance and Financial Advisors
350 Bloor Street East, 2nd Floor, Toronto ON M4W 3W8
P:(416) 444-5251 or 1-800-563-5822 • F:(416) 444-8031
www.caifa.com • info@caifa.com**