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COMMENT

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RIGHTS OR THINGS

In the year of death, a taxpayer will often have a number of different types of income, such as "regular" earned income to the date of death, income from the deemed disposition of capital property, and income from the realization of any registered plans. Some income items fall into the definition of a *right or thing* and may enjoy favourable income tax treatment.

In general terms, a right or thing is a receivable amount that has been earned by the date of death but has not yet been collected. Examples of rights or things include dividends that have been declared but are unpaid, matured uncashed bond coupons, and amounts that are payable to an employee at the time of death but that have not yet been paid (for example, salary accrued to the end of the most recent pay period, unpaid commissions or bonuses, and unused vacation pay credits). For individuals on the cash basis of accounting (e.g., farmers and fishers), rights or things will also include harvested crops, livestock, accounts receivable, supplies on hand, and inventory.

It is important to distinguish a right or thing from other types of income that may be paid on a periodic basis. For instance, a right or thing does not generally include accrued interest because, while it has been earned by the date of death, it is not receivable until the next due date. For employment-related rights or things, the deceased employed must have had, on the date of death, an enforceable claim to an amount that related to a pay period ending prior to that date. Thus, an employee might have accrued employment income as of the date of death, but if the amount would not have been receivable until a later pay day, it is not a right or thing. Capital property, eligible capital property, and income from a registered plan, such as a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF), are also not considered to be rights or things.

Where it is not clear if an amount is a right or thing, the Canada Revenue Agency (CRA) will generally resolve this issue in favour of the taxpayer.

Several options are available to the executor for reporting the deceased's rights or things and the executor can use the option that is most advantageous. Rights or things can be transferred to estate beneficiaries, included in an optional tax return reporting only those rights or things, or reported on the deceased's terminal tax return.

The executor may distribute some, or all, of the rights and things to one or more beneficiaries of the estate. The beneficiary would have to report the income on his or her own tax return and would be liable for any associated income tax. This transfer removes the reporting of those rights or things from the terminal tax return or a separate rights or things tax return. For such a transfer to take place, however, the beneficiary must be entitled to the right or thing and the value thereof as a distribution

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from the estate. This means that the executor must follow the testator's wishes under the will in determining how best to minimize income taxes through a distribution of rights or things.

Rights or things not allocated to beneficiaries may be reported on the terminal return or a separate tax return in the year of death. The advantage of using a separate tax return is that it is possible to claim a number of personal tax credits on the separate return as well as on the deceased's ordinary terminal return. In addition, any taxable income on the separate tax return is subject to its own set of marginal tax rates. Note that if the executor elects to file a separate tax return for rights or things, then all of the rights or things not allocated to beneficiaries must be reported on that separate return.

Planning involves minimizing the overall taxation of rights or things by determining which items and amounts to allocate to beneficiaries and whether to file a separate tax return for the remaining rights and things.

I/R 7401.00

EMPLOYEE DEATH BENEFIT

The best tax result is achieved when a payment is deductible by the paying party and non-taxable to the receiving party. The payment of an employee death benefit can fit within this definition.

The gross amount of a death benefit is the amount received by a taxpayer, on or after the death of an employee, in recognition of that employee's service. In order to be deductible by the employer, the payments must be reasonable, taking into consideration the employee's position in the company and length of service. The amount could be paid as a lump sum or as a series of payments continued for an extended period of time as long as the employer's requirement to pay the benefit is evidenced by an explicit statement in the employee benefit plan or the employee's contract of employment. The payment may also include the employee's unused sick leave where there is a requirement for the employer to make such a payment.

Certain types of payments made by an employer would not be considered the payment of an employee death benefit. Such non-qualifying payments include: payments from the company pension plan; payments in respect of accumulated vacation pay; payments under the Canada / Quebec pension plan; payments under a deferred income plan; and payments for overtime earned prior to death.

In general, the first $10,000 of the gross amount of a death benefit is tax-free to the recipient. The amount in excess of $10,000, which for income tax purposes is defined as the "death benefit," is taxable. The $10,000 exemption cannot be multiplied by naming multiple beneficiaries or by having the money paid over several years.

Where multiple beneficiaries receive portions of the gross death benefit payment, the surviving spouse or common-law partner of the employee has priority to receive the first (tax-free) $10,000. Where the death benefit is paid to multiple beneficiaries, none of whom is a surviving spouse, the tax-free entitlement is prorated among them based on each beneficiary's entitlement to the total amount of the death benefit. Below are a number of examples that illustrate the general rules.

Examples:

1. Assume that $18,000 is paid equally to the employee's surviving spouse and child. The spouse would be entitled to receive $9,000 tax-free, and the child would be entitled to receive $1,000 of the $9,000 payment tax-free.
2. Assume that $24,000 is paid equally to the employee's surviving spouse and child over two years (i.e., $6,000 each per year for two years). In year one, the spouse would receive $6,000 tax-free, and the child would receive $4,000 of the $6,000 payment tax-free. In year two, the spouse would receive $4,000 of the $6,000 payment tax-free, and the child would be fully taxable on the second $6,000 payment. In addition, the child's non-taxable portion for year one would be reassessed and the child would be required to include the $4,000 in income for that year.

3. Assume that $20,000 is paid to the employee's two surviving children, $12,000 (i.e., 60%) to one and $8,000 (i.e., 40%) to the other. The first child would be entitled to receive $6,000 of the $12,000 payment tax-free based on the proration of the exemption. The second child would be entitled to receive $4,000 of the $8,000 payment tax-free.
4. Assume that $12,000 is paid from each of two employers to the same beneficiary because of the death of the same person. Regardless of the number of sources, the beneficiary is entitled to receive only $10,000 tax-free as a result of the death of the single person.

The employee death benefit can be significant because of the substantial tax benefits that can be generated. Planning for the payment of the employee death benefit can involve amendments to employee benefits plans or contracts of employment.

I/R 2400.00

COLLATERAL INSURANCE

In most cases, the payment of a life insurance premium is not a tax-deductible expense because the payment is considered to be on account of capital. This view was clearly articulated in the case of Antoine Guertin Ltée, where the judge commented that the payment of a life insurance premium returned capital and was therefore on account of capital. However, the Income Tax Act provides an exception and allows for the deduction of a life insurance premium, or a portion thereof, if the policy is used as collateral for a loan.

To qualify for the deduction, all of the following criteria must be met:

- the policy is owned by the borrower;
- an interest in the policy is collaterally assigned to the lender;
- the loan is from a restricted financial institution;
- the loan interest expense is tax deductible; and
- the collateral assignment is required by the lender.

If these criteria are met, the amount of the tax deduction is the lesser of the premiums paid under the policy and the "net cost of pure insurance" in respect of the year. A further limitation is the overall reasonableness of the amount, which is generally determined by a comparison of the death benefit of the policy with the outstanding amount of the loan.

Even though the above criteria appear to be relatively clear, a number of issues have arisen in interpreting and applying them.

1. The criteria require that an "interest" in an insurance policy be collaterally assigned. This requirement appears to allow the partial collateral assignment of an insurance policy or the collateral assignment of an interest in a "split dollar" policy, provided the borrower owned the portion of the policy being assigned.
2. Under the criteria, the loan must be from a restricted financial institution. In general terms, a restricted financial institution is defined to mean a bank, a credit union, an insurance company, or a corporation whose principal business is the lending of money to persons who are dealing at arm's length. This means that in situations where the loan is between controlled corporations or between a corporation and its shareholders, a deduction for the payment of the insurance premium would not be allowed.
3. There is some debate over the interpretation of the fourth criterion, that "the interest is tax deductible." The issue centres on the word "the." One school of thought argues that the entire amount of interest must be tax deductible and, if any part of the interest deduction is denied, then no deduction is allowed for the insurance premium. One example of where the interest expense deduction might be limited would be in the case of money borrowed to buy an annuity; there is an express limitation on the deduction of interest expense to the amount of taxable portion of the annuity. In such a case, it is possible that the amount of deduction permitted would be prorated

according to the amount of interest that is tax-deductible.

4. As noted above, the deduction is the lesser of the premiums paid and the net cost of pure insurance. The payment of premiums will depend on the type of insurance policy chosen. In the case of term insurance and universal life insurance, "premium paid" has been defined as the actual payment made in the taxation year. Whole life or par insurance may also have "premium payments" even where the policyholder has not actually made a payment. For instance, some whole life contracts allow the policyholder to elect to apply the annual policy dividend to the payment of the premium. In such cases, the annual premium is being "paid" and a deduction should be allowed. However, it is necessary to review the policy contract to ensure that the annual premium is being paid out of such dividends rather than internal policy values.

5. Many financial institutions offer group creditor insurance to borrowers. It should be noted that the collateral insurance deduction is not available for the cost of such insurance coverage. The lending institution is both the owner and beneficiary of the life insurance coverage and, as such, there is no collateral assignment of the coverage. A further implication of group creditor insurance is that the borrowing corporation would not be entitled to a credit to its capital dividend account for the insurance proceeds at the death of the life insured, since they are payable to the lender as beneficiary.

6. Where the outstanding loan amount varies throughout the course of the taxation year, the Canada Revenue Agency (CRA) will allow the use of the average outstanding amount of the loan. Through a response to an inquiry, the CRA has indicated that it will not consider the amount of the other assets assigned to the lending institution in determining the reasonableness of the amount of premium that would be tax deductible.

While the deduction for the payment of an insurance premium seems like a relatively straightforward business expense, there are a number of issues that must be addressed to ensure such premiums are in fact deductible.

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