Advocis COMMENT

NUMBER 222 – NOVEMBER/DECEMBER 2003

INSURED GIFT PLANNING

The 2000 federal budget expanded gift planning opportunities by allowing a tax credit for certain direct designations in favour of a charity. The provisions deem that a gift has been made at the time of death when a charity is named as the beneficiary of a life insurance policy, registered retirement savings plan (RRSP), or registered retirement income fund (RRIF). Before these rules were introduced, a charity was considered to receive such proceeds as a contractual right (i.e., as the beneficiary) and not as a gift from the deceased. As such, no charitable donation receipt could be issued.

In the case of life insurance proceeds, the rules in the *Income Tax Act* now allow such a gift to occur when the following conditions are met.

1. The policyowner and life insured must be the same person. This criterion would exclude third-party contracts such as one involving a spouse owning a policy on the life of another spouse or parents owning a policy on the life of their child.
2. Funds are transferred to the charity as a result of the life insured's death under the contractual provisions of the insurance policy.
3. Immediately prior to the policyowner's death, his or her consent would have been required to change the beneficiary designation under the life insurance policy and the charity was neither the owner of the policy nor an assignee.
4. The transfer of funds must be completed within 36 months of the time of death (unless an extension is granted by the Minister of Finance).

If all the above criteria are met, then the policyowner is deemed to have made a gift equal to the death benefit proceeds received by the charity. The timing of the gift is deemed to be the moment before death. The gift can be claimed as a charitable donation on the deceased's terminal income tax return and any unused portion can be carried back to the year prior to death. The donation limit for the year of death and the immediately preceding year is 100 per cent of net income for that year, rather than the usual 75 per cent limit.

Similar criteria apply to the designation of RRSP or RRIF proceeds to a charity. In that case, the individual must be the plan's annuitant immediately before his or her death and the charity must receive the funds (within the 36-month limit) as the plan beneficiary and as a consequence of the death. With respect to an RRSP or RRIF, a taxpayer should realize that an income tax liability, calculated on the value of the registered proceeds, must be reported on the terminal tax return. The charitable donation tax credit, however, will provide tax relief against this liability.

This direct-funding strategy eliminates risks that may otherwise be present where a charitable bequest is made in a will and a life insurance policy payable to the estate is used to fund the obligation. Using a direct beneficiary designation eliminates the risks and costs associated with probate, estate creditors, and perhaps other beneficiaries who believe they are entitled to the proceeds.

In response to questions regarding the above requirements, the Canada Customs and Revenue Agency (the "CCRA") has commented on the third condition (which applies only to the designation of life insurance proceeds). Specifically, CCRA officials were asked how they would interpret this in a situation involving an irrevocable beneficiary designation. Under insurance law, the policyowner cannot change a beneficiary designation that has been made on an irrevocable basis without the consent of the beneficiary. In response, the CCRA stated that a policyowner who designates a charity as an irrevocable beneficiary would not be deemed to have made a charitable gift on payment of the proceeds. It should be noted that CALU has responded to the CCRA's opinion, challenging this interpretation.

Even though these rules were introduced several years ago, they are still relatively new and there are still a number of unanswered questions about the mechanics of direct charitable designations.

I/R 1600.02

YEAR-END TAX PLANNING

With a little planning, there is still time left to reduce your income tax liability for the current year. It is easy to get caught up in thinking about how to fund your tax liability, when in fact there are steps that could be taken right now to help alleviate some of that future liability.

One simple idea to help reduce your taxes is to ensure that all payments for tax-deductible items have been paid by the end of the year. The *Income Tax Act* specifically sets out the types of payments that must be made in the year in order for the amounts to be deductible for tax purposes. The wording of the phrase paid in the year is important, and it should be distinguished from amounts that are payable in *respect of the year*.

The following items can be claimed on an individual's current year tax return only if they are *paid in the year*.

Charitable donations and political contributions. While not technically deductible items, a tax credit is available for charitable donations and political contributions made in the year.

For charitable donations, the federal non-refundable tax credit is equal to 16 per cent of the first $200, and 29 per cent on the total amount of charitable donations in excess of $200. Each of the provinces also provides a tax credit for charitable donations, based on a formula that is similar to that used to calculate the federal credit.

For contributions to a federal political party, the federal tax credit is equal to 75 per cent of the first $200, 50 per cent of the next $350, and 33 1/3 per cent of the next $525 (for a maximum credit of $500 if $1,075 or more is contributed). The provinces each have tax credit formulas that recognize contributions to provincial political parties.

Retirement compensation arrangement (RCA) contributions. An employer is allowed a tax deduction for reasonable contributions, made on behalf of an employee, to an RCA trust. In addition, an employee is allowed a tax deduction for amounts contributed to an RCA in the year, if those contributions are required as a condition of employment.

Spousal support payments. Spousal support payments are only deductible in the year in which they are paid. The rules also require a spousal support payment to be made "in respect of the year." These two requirements, taken together, have been interpreted to mean that if an individual advances support payments to a (former) spouse or common-law partner, such an advance is not tax deductible in the current year or even when the obligation arises. Accordingly, it is important to ensure that any spousal support payments made in the year actually relate to that year.

Trigger accrued capital losses. Taxpayers with investments should review their portfolios and, if circumstances warrant, they should consider triggering accrued capital losses. Such a strategy can be valuable if the taxpayer realized capital gains during the current year. Since capital losses can only be claimed against capital gains, triggering a capital loss could reduce or eliminate any capital gains realized during the year. Capital losses can also be carried back three years and forward indefinitely. It is important to note that a deduction for capital losses will be denied if the identical asset is repurchased within 30 days of the sale.

The following items may be deductible on the current year's income tax return if payable *in respect of the year*.

RRSP contributions. It is fairly common knowledge that RRSP contributions made in the first 60 days of the calendar year can be claimed in respect of the prior year. The extra time permits individuals to estimate their potential tax liability and determine the desirability of making a contribution.

Interest expense. To be deductible, interest must be paid in the year or be payable in respect of the year (depending on the method regularly followed by the taxpayer in computing income). Individual taxpayers generally report income on a cash or paid basis, in which case interest should be paid in the year to ensure deductibility. Where the interest expense relates to an income-splitting arrangement between non-arm's-length parties (for example, spouses), the interest has to be paid within 30 days after year-end in order to avoid having the attribution rules apply to the arrangement. However, remember that this attribution rule does not change the timing of the interest deduction; interest that is paid within this 30-day window will only be deductible in the year in which it is paid.

Tax planning is important throughout the entire year, but by taking stock of opportunities and tax issues prior to year-end, you may be able to fine-tune your plans to minimize the tax liability.

I/R 7400.00

COLLATERAL INSURANCE

In limited circumstances, the federal Income Tax Act (the "Act") allows a tax deduction for premiums paid under a life insurance policy, where the policy is assigned as collateral under a loan agreement. The provision allows this deduction regardless of the type of policy (i.e., universal life, whole life, term life, creditor group term life), provided all of the prescribed conditions are met.

The specific provision provides a deduction for the lesser of two amounts. The first amount is the premiums payable under a life insurance policy (other than an annuity contract) for the year where the interest in the policy is assigned to a restricted financial institution in the course of borrowing from the institution, the interest payable on the loan is deductible, and the assignment is required by the institution as collateral for the loan. The second amount is the net cost of pure insurance for the policy for the same period. The provision also requires that the amount deductible must reasonably relate to the amount owing by the taxpayer to the institution under the loan.

As straight-forward as this provision seems, there are several important conditions to observe. Some of these include:

- the policy must be collaterally assigned;
- the lender must be a restricted financial institution (a defined term that includes insurance companies, banks, trust companies, and credit unions);
- the assignment must be required by the lender as collateral for the loan; and,
- the interest payable on the loan must be tax deductible by the borrower.

These conditions are fairly easy to meet. However, careful compliance with all of the details is necessary to ensure that the deduction will be available. For example:

- The provision refers to the premiums payable by the taxpayer, which the CCRA interprets to mean that the taxpayer taking the deduction must also be the policyowner.

- The provision requires that "the" interest be tax deductible. An issue may arise when the deduction is restricted (i.e., the interest expense is not fully deductible). Since all of "the" interest is not deductible, the collateral insurance deduction may be denied. An example of restricted interest deductibility would be in the case of money borrowed to purchase an annuity.

Once the above conditions have been met, the lesser of the premium paid and the net cost of pure insurance of the policy for the year is deductible. Note, though, that the amount deductible will be prorated if the amount of insurance in place exceeds the amount of the loan being secured by the collateral assignment. Also remember that, according to the CCRA, the premium must actually be paid in the year – the use of internal policy funds (other than pre-paid premiums) to cover the amount will not generally qualify.

I/R 900.01

NON-COMPETITION CLAUSE – AN IMPORTANT UPDATE

The last issue of Comment (September/October 2003, issue #221) included an article on the income tax treatment of non-competition payments. The article reviewed a recent Federal Court of Appeal decision which had concluded that such payments were not taxable under the Income Tax Act. We noted that the Department of Finance might propose an amendment to the Act in response to this decision.

On October 7, 2003, Finance issued a news release stating that such an amendment will be made. Such payments will generally be treated on income account. However, in certain circumstances, capital gains treatment may be available where the non-competition agreement relates to the sale of a business. These changes apply to amounts received or receivable after October 7, 2003, unless the amount is received before 2005 under a written arm's-length agreement entered into on or before that date.

I/R 7401.011

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

This commentary is published by Advocis in consultation with an editorial board comprised of recognized authorities in the fields of law, life insurance, and estate administration.

Advocis is a voluntary, not-for-profit professional association whose members, gathered in 50 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.

™ Trade-mark of Canadian Association of Insurance and Financial Advisors carrying on business as Advocis

Published by: **Advocis**
350 Bloor Street East, 2nd Floor, Toronto, ON M4W 3W8
P: (416) 444-5251 or 1-800-563-5822 • F: (416) 444-8031
www.advocis.ca • info@advocis.ca

Publication Agreement
# 40069004

Copyright 2003

ISSN 0382-7038

All Rights Reserved