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## THE HAZARDS OF JOINT TENANCY

Sometimes an estate planning strategy is adopted to accomplish one objective, but it unintentionally creates other issues. One such strategy is the concept of joint tenancy, which involves the transfer of assets into joint title.

Transferring assets into joint title can accomplish some, or all, of the following objectives:

- **Probate planning.** Ownership of assets held in joint tenancy will transfer to the surviving joint tenant upon the other person's death. Since this transfer is automatic, the asset does not pass through the deceased's estate and, therefore, is not subject to probate. By transferring an asset in this manner, the estate can avoid probate fees, which in some provinces can be as high as 1.5 per cent of the value of the asset.
- **Confidentiality.** Assets that transfer by right of survivorship are not subject to public scrutiny, as they would be if they passed through probate. Confidentiality is often a motivating factor, even more so than monetary concerns, since the will and the inventory of assets passing through probate become public documents.
- **Efficiency.** Assets that transfer by right of survivorship require less legal documentation to effect the change in ownership. Transfer by right of survivorship can simplify the process, especially in situations where it is already known that certain assets are to pass to particular beneficiaries.
- **Unequal inheritances.** Transfers of assets to surviving joint tenants may produce an unequal division of the deceased's property values among the various beneficiaries.
- **Legal issues.** Transactions involving assets held in joint tenancy will require the agreement of all of the owners during their lifetimes. For example, as part of an estate plan, a parent may transfer a cottage or residential property into joint tenancy with an adult child. But that parent could later be prevented from mortgaging, selling, or leasing the property if the child, as co-owner, refuses to consent. As well, the process may be lengthened because the consent and signature of all co-owners are required on all legal documentation.
- **Taxation.** Transferring an asset into joint title is a disposition for tax purposes, possibly triggering an income tax liability on any accrued capital gain, or on recapture of depreciation.

While joint tenancy provides a number of advantages, it can result in some of the following unintended consequences when sufficient care is not exercised in the estate planning process:

The original owner will be deemed to have disposed of an interest in the property for the fair market value of that interest. For instance, if the parent transfers a property, such as a cottage, into joint title with a child, then one-half of the property is deemed disposed of. If the parent transfers the property into joint title with three children, then three-quarters of the property is deemed disposed of. While the parent may be able to utilize the principal residence exemption to eliminate or reduce the tax on the capital gain, the parent will be unable to shelter gains on other properties they own and occupy. It is important to consider both the immediate and longer-term implications. It is equally important to consider whether the current sole owner of the property has sufficient liquidity to handle the income tax liability if the capital gains exemption cannot be used.

- **Creditors.** As an asset of the new co-owner, the property becomes exposed to the new co-owner's creditors. Creditors trying to collect debts from

the new co-owner may seek legal recourse against an asset held in joint title. The property could also be considered a family asset that could become subject to division upon a breakdown of the new co-owner's relationship. Quite unknowingly, a strategy implemented for estate planning purposes could have much broader ramifications for the original owner during his or her lifetime.

- **Testamentary trusts.** Assets held in joint title transfer automatically to the surviving co-owner. Since this right of survivorship means that the asset does not pass through the testator's estate, the opportunity to transfer the asset to a testamentary trust for the benefit of beneficiaries is lost.

Estate planning is an art and not an exact science; with the implementation of any strategy, other issues might arise. Always consult an experienced planner who knows the benefits of the appropriate strategy and how to balance them against the sometimes-hidden costs.

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## NON-COMPETITION CLAUSE

In most circumstances, when a taxpayer sells something of value and the proceeds are greater than the taxpayer's cost, the excess amount will be taxable.

A recent court case, *Manrell v. the Queen* ("Manrell"), put this view to the test. In this case, the taxpayer agreed to sell his shares in three operating companies, and also received an amount for signing a non-competition agreement with the purchaser.

The Crown argued that the right to compete was property and, as such, the disposition should be subject to capital gains treatment.

The taxpayer argued that the right to compete was not property or a right as defined in the federal Income Tax Act (the

"Act"), and that even if the right to compete was property, he did not dispose of it. The Act defines property to include "a right of any kind whatever." The taxpayer argued that the statutory definition of property envisions an exclusive right to make a claim against someone else, whereas the right to compete is not an exclusive right since it is available to everyone.

The Tax Court agreed with the Crown's argument in a 2002 decision. However, the Federal Court of Appeal overturned the Tax Court decision, and on March 11, 2003, ruled in Manrell's favour. The Federal Court of Appeal based its decision on the definition of the word "property." First, it concluded that the

ordinary meaning of property entails an exclusive right to make a claim against someone else, which does not include a right such as the right to compete in business that is shared by everyone. Second, based on an historical perspective of the word property in the Act and in jurisprudence, the court could not find any support that the phrase “a right of any kind whatever” extended the meaning of the word property beyond its ordinary meaning, or that the word property is so broad that it encompasses every conceivable right.

It does not appear that the Crown will appeal this decision to the Supreme Court of Canada. However, the Department of Finance may propose an amendment to the Act. In the meantime, a vendor of shares should consider negotiating a deal that includes a separate non-competition payment. Be sure to seek professional legal and tax advice in structuring such an agreement.

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## ROLLOVER OF A LIFE INSURANCE POLICY

**T**ransferring ownership of an interest in a life insurance policy is a disposition for tax purposes. Such a transfer usually results in a policy gain equal to the excess of the proceeds of the disposition over the adjusted cost basis (ACB) of the interest. However, the federal Income Tax Act (the “Act”) provides for the transfer of a life insurance policy between certain individuals at the ACB of the policy. This type of “rollover” allows the current owner to avoid triggering an income tax liability on the disposition of an interest in the contract.

### **Between spouses or common-law partners**

The first type of rollover applies to the transfer of an insurance policy (including an annuity contract) between spouses or common-law partners who are both Canadian residents at the time of the transfer. The insurance policy can be on any life (i.e., their own, each other, children, other relatives, even business partners). In addition, a policy can be rolled over to a former spouse or former common-law partner, as long as the transfer is made in the settlement of rights from the breakdown of their relationship.

Even though there is a transfer of the interest in the policy, remember that the spousal attribution rules may apply. These

rules will tax any future policy gains in the hands of the transferor spouse or common-law partner, assuming that both individuals remain Canadian residents and that their relationship is intact at the time the gain is realized.

### **Between parent and child**

The second type of rollover applies to the transfer of an insurance policy (other than an annuity contract) from parent to child. The provision provides that a policyholder’s interest in a policy on the life of his or her child can be transferred for no consideration to his or her child. The definition of child includes natural and adopted children, grandchildren and great-grandchildren, as well as spouses and common-law partners of those “children.”

In this scenario, attribution will only apply where a policy is transferred to a minor child (i.e., a child under 18 years of age), and the subsequent policy gain is realized while that child is still a minor.

The wording of the legislation provides opportunities for planning. Note that the “child” whose life is insured does not necessarily have to be the “child” who becomes the new owner of the interest in the policy. Because of this wording, the following types of transfers can be accomplished on a rollover basis:

- A parent could take out a life insurance policy on the life of his or her minor child and later transfer the policy to that child. This strategy would allow a parent to acquire life insurance protection on the life of the child, to ensure insurability of the child, and to lock in insurance rates at a younger age. When the child reaches the age of majority, or when the parent is ready to give up control of the life insurance policy, it can be transferred to the child.
- A grandparent could take out a life insurance policy on the life of his or her child, and later transfer the policy to his or her grandchild. One benefit of this type of transfer is that the grandparent could over-fund the life insurance policy, and the grandchild could later use the built up cash value to fund a university education.
- A parent could take out a life insurance policy on the life of his or her son- or daughter-in-law and later transfer the policy to his or her child. This could allow a parent to ensure that the newly married child has adequate life insurance protection while maintaining control of the policy, and later transfer the policy when such control is no longer necessary.

The above strategies are possible because the child whose life is insured

does not have to be the child who becomes the new owner of the interest in the policy.

A few cautionary notes should be made in respect of transferring an insurance policy on the life of a child:

- The Act refers to a life insurance policy where a child is *the* person whose life is insured. There does not seem to be an opportunity to use this rollover provision to transfer a life insurance policy where the child is only one of the lives insured, whether on a joint basis or multi-life basis.
- Secondly, the Act requires that the new owner be the child of the transferring policyowner. This requirement would appear to preclude a trust taking ownership of the policy from the parent.

It should be noted that the Act does not provide a policy rollover under any other circumstances. While a taxpayer can accomplish the rollover of most types of property into a corporation, for example, an insurance policy is not one of the eligible types of property.

An individual may want to reorganize his or her affairs several times throughout life as circumstances change or estate planning objectives evolve. The ability to move insurance policies on a tax-free basis may be very valuable when reorganizing an estate plan.

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