TAX NEWSLETTER **Summer 2013**

An Independent Member Firm of DFK Canada Inc. and DFK International

Life Insurance Policy Transfers

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There are some significant planning opportunities when considering a transfer of a life insurance policy from an individual to a related corporation, or vice versa. However, be mindful of the rules before making the transfer to avoid any unanticipated tax consequences.

In accordance with the Income Tax Act of Canada, when an individual, or corporation, carries out a non-arms length transfer of a life insurance policy, the policyholder is deemed to have received proceeds equal to the cash surrender value ("CSV") of the policy (amount which would have been received by the policyholder if the policy was surrendered) and the recipient to have acquired the policy at the CSV. The CSV may not equal the true fair market value ("FMV") of the policy which may be higher in many cases due to factors including current insurability, future premiums and life expectancy.

To the extent that the CSV of the policy is in excess of its adjusted cost basis ("ACB"), the taxpayer disposing of their interest will be required to include this difference in their income for the year. The recipient's ACB is deemed equal to the CSV at the time of the transaction. Assuming the policy is not transferred in the future, and is held to maturity, this would not result in any future tax due to proceeds received on the death of the insured being received on a tax free basis.

Planning opportunities exist where this CSV differs from the FMV of the policy based on the proceeds of disposition being deemed equal to the CSV when disposed/transferred.

Assume a life insurance policy with the following tax attributes is transferred between a corporation and an individual shareholder/employee:

FMV $750,000
CSV $50,000
ACB $50,000

The tax consequences to the policy holder will be a disposition for CSV creating no tax liability in our example as this does not exceed the ACB. Despite the deemed value being the CSV, the recipient would still receive an asset with a FMV equal to $750,000.

The recipient must still pay FMV to the policyholder on the transfer. In our example, to the extent a recipient employee or shareholder does not pay the extra $700,000 they will be taxed on any shortfall as an income inclusion on their personal tax return. CRA has indicated they would accept that this income inclusion increases the policy's ACB.

Based on this outcome, it is generally not desirable to transfer the policy from a corporation to an individual, unless there is a specific reason for moving the life insurance policy out of the corporation (e.g., in contemplation of a future sale).

In the case of an individual transferring their life insurance policy into the corporation, the above transfer would allow for the extraction of $750,000 out of the corporation on a tax free basis with no negative tax consequences to either party, making this an attractive option.

If you are an individual with a personally held life insurance policy and would like to review the planning opportunities available to you, we encourage you to consult your DFK professional advisor.

Inside this issue:

Special points of interest:

- *Personal tax instalments:*
  - *September 15, 2013*
  - *December 15, 2013*
  - *March 15, 2014*
  - *June 15, 2014*
- *BC is back to being a non-HST province, while PEI is now an HST province.*
- *In anticipation of prescribed rate possibly increasing on October 1, it may be prudent to lock-in prescribed rate loans today at 1%.*

Proposed Changes to Taxation of Trusts and Estates

Linda Woo, CPA, CA, Principal, Segal LLP, Toronto, ON, DFK Affiliate Firm

Currently, testamentary trusts and estates are subject to tax at graduated rates applicable to individual taxpayers. This is in contrast to an *inter vivos* trust which is subject to tax at the highest marginal rate on all of its taxable income. Given that the federal income tax rate for 2013 starts at 15% on the first $43,561 of taxable income, and increases gradually to 29% on taxable income of $135,055 or greater, factor in the provincial taxes, one can see how, with proper planning, significant tax savings can result from the use of testamentary trusts.

Furthermore, the benefit of the graduated tax rates can be multiplied by having an individual's will create several testamentary subtrusts (i.e., one for each of the spouses, children, and/or grand-children). The income earned in each trust could either be taxed in the trust (at graduated tax rates) or allocated among the beneficiaries of each trust.

This perceived benefit may have been what prompted the Government to announce in the 2013 Federal Budget, the future release of a consultation paper on potential measures to eliminate the tax benefits that arise from the taxation of certain trusts and estates at graduated rates. On June 3, 2013, the Department of Finance released a consultation paper addressing its concerns that the graduated rate system for testamentary trusts is not fair and that it negatively affects government tax revenues. The Department proposes, among other things, to eliminate graduated tax rates and instead apply a “flat top-rate” for testamentary trusts, as well as for estates after the third year after the date of death. These proposed changes would apply to new and existing arrangements for the 2016 and later taxation years.

Although access to graduated tax rates are a benefit of using testamentary trusts, quite often testamentary trusts are used for non-tax reasons. Consider, for example, a trust established under a will for an individual (who is not a minor) who is incapable of handling his or her own property. Upon the death of the testator, the assets would be transferred to the trust and administered under the terms set out in the will based on the wishes of the deceased and the individual would not have access to the assets.

However, under the proposed rules, the income accumulating within the trust would now be subject to tax at the top marginal rates. Contrast this to the situation if the individual were to receive the assets directly, any income earned by the individual would be subject to individual graduated tax rates. In the former situation, the individual would be at a disadvantage since less after-tax funds would be available for future use. In the future, the testator may think twice about using a trust given the differing tax result.

Submissions to the Department of Finance regarding the proposed changes can be made until the December 2, 2013 deadline. If these proposals become law, traditional estate planning and administration strategies will undoubtedly change.

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Dividend Changes in 2014

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Most reporting relating to the 2013 Federal and Ontario Budgets did not mention tax increases for small business owners. However, changes to the dividend tax credit system will significantly increase taxes on the majority of dividends paid by small businesses. The tax increases are effective on January 1, 2014. The budget changes will affect how corporations should approach their tax planning in 2013 and 2014. These changes affect both corporations carrying on active businesses as well as holding companies that own portfolio investments.

It is important to understand that there are two main types of dividends: eligible and ineligible. Eligible dividends are generally paid by public companies, and private companies with active business income over $500,000. The taxation of eligible dividends has not changed. It is the treatment of ineligible dividends (generally paid by small business) that has changed.

The changes to the taxation of ineligible dividends can be summarized as follows:

- The tax rates on ineligible dividends for all taxpayers have increased by approximately 2.5% to 3.0%. For example, for an Ontario taxpayer earning between approximately $135,000 - $509,000, the tax rate on ineligible dividends has increased from 32.57% in 2013 to 34.92% in 2014.
- For active businesses, it will still be more beneficial to pay dividends than salaries in 2014, but the amount of the benefit will be reduced in 2014.
- The “gross-up” on ineligible dividends will decrease from 25% to 18%. This is actually helpful for people receiving income-based benefits such as the age credit, and for taxpayers that have their Old Age Security benefits clawed back.
- For taxpayers with no income, the amount of dividends that they can receive tax-free has been reduced from approximately $40,000 in 2013 to approximately $35,000 in 2014. Students can receive more than this since they have tuition and education tax credits available to them.
- For holding companies that earn investment income, these changes have a large impact on Ontario shareholders earning between approximately $135,000 - $509,000:
    - The personal taxes on ineligible dividends have increased from 32.57% in 2013 to 34.92% in 2014.
    - In both 2013 and 2014, many companies receive savings of 33.33% by paying dividends.
    - In 2013, there was a combined savings by paying a dividend of 0.76% (33.33% – 32.57%). In 2014, there will be a cost of 1.59% (34.92% - 33.33%). Generally stated, taxpayers will be better off to not pay dividends in 2014.
- For holding companies with shareholders earning less than $87,000 (and not earning OAS benefits), it will still be beneficial to receive dividends in 2014.

Things to do in 2013

Based on the budget changes, planning that should be done in 2013 includes the following:

For active businesses:

- Review the salary/dividend analysis with your accountant. While dividends are cheaper, other factors such as RRSP limits, CPP costs and benefits, and Employer Health Tax costs should be reviewed.
- Consider paying more dividends in 2013, and reducing the dividends to be paid in 2014. If the business requires the cash for business operations, the shareholder can lend it back to the company.

For investment holding companies:

- If a company is subject to refundable taxes, consider paying more dividends in 2013.
- Pay ineligible dividends in 2013 and eligible dividends in future years (since eligible dividends are unaffected by the changes).

It’s not too late to start your 2014 planning. Contact one of our experienced tax planning professionals to discuss your planning options.

Can a Not-for-Profit Make a Profit?

Leslie Milton, CPA, CA, LPA, CFP, Associate Partner, Ginsberg Gluzman Fage & Levitz, LLP, Chartered Accountants, Ottawa, ON, DFK Member Firm

The short answer is…maybe.

To effectively answer the question "can a not-for-profit make a profit," we must first review the present legislation.

Section 149(1)(l) of the *Income Tax Act* explains that an association is exempt from tax if "it is organized exclusively for social welfare, civic improvement, pleasure, recreation, or **any other purpose except profit."**

Interpretation Bulletin IT 496R further explains "an Association may earn income in excess of expenditures provided the requirements of the Act are met. However, if a material part of the excess is accumulated each year and the balance of the accumulated excess is greater than the association's needs to carry on its non-profit activities, the profit will be considered to be one of the purposes for which the association was operated."

It's been almost three years since Canada Revenue Agency (CRA) launched their NPO "risk identification project" to review tax compliance in the non-profit sector. The result has been the issuance of education letters to those found not to be in compliance.

Things to consider

What defines a reasonable surplus for an NPO to maintain? There is no concrete number. It depends on the operations and plans of the organization. The issue should be discussed by the Board on an annual basis.

The next question that needs addressing is when is an NPO "carrying on a business?" According to IT 496R, it is a "question of fact." CRA will consider whether:

1) The business is operated in a normal commercial manner;
2) Its goods or services are not restricted to members and their guests;
3) It is operated on a profit basis rather than a cost recovery basis; or
4) It is operated in competition with taxable entities carrying on the same trade or business.

Generally, CRA will not consider the venture to be in breach of the *Income Tax* Act if the carrying on of a business or trade is directly attributable to, or connected with, reaching the non-profit goals and activities of the organization.