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Corporate-Owned Life Insurance

ROGERS ENTERPRISES (2015) INC. - TAX COURT FINDS THAT AN INCREASE IN A CAPITAL DIVIDEND ACCOUNT BALANCE IS NOT A TAX BENEFIT UNDER THE GAAR

Sanjana Bhatia, *Sun Life Financial*

Since the General-Anti Avoidance Rule (GAAR) was enacted in 1988, only a few cases have dealt with the issue of whether there has been a "tax benefit". Rogers Enterprises (2015) Inc. (Rogers) is a recent example of where the Court has held that the series of transactions the taxpayer entered into did not result in a tax benefit. As such, Rogers is a significant and important decision because it adds to the GAAR jurisprudence that an increase in a tax attribute is not a tax benefit under the GAAR. In this article Sanjana Bhatia discusses Rogers, which was decided in favour of the taxpayer.

Creditor Protection

DOES THE CANADA REVENUE AGENCY HAVE THE POWER TO SEIZE LIFE INSURANCE PROCEEDS TO SATISFY THE DECEASED'S TAX LIABILITY?

Glenn R. Stephens*, PPI Advisory*

It is well understood that life insurance policies provide a level of creditor protection, primarily under each province's *Insurance Act*, that is not available to other financial products. In this article Glenn Stephens considers whether life insurance also enjoys protection from the broad collection powers provided to the Canada Revenue Agency ("CRA") under section 160 of the Income Tax Act (Canada) .This section provides the CRA with the ability to seize funds or other property transferred by a tax debtor to a non-arm's length party. Where this section applies, the transferee becomes jointly and severally liable with the tax debtor for the latter's tax liability. The particular focus of this article is whether the powers granted under this section allow the CRA to seize insurance death benefit proceeds paid to a non-arm's length party under a policy insuring the life of the tax debtor. There are strong arguments to suggest that the CRA may be unable to do so.

Estate Planning

STEP CANADA CRA 2020 ROUNDTABLE – QUESTIONS OF INTEREST FOR INSURANCE PLANNING

Kim G.C. Moody, *Moodys Tax Law LLP*

STEP Canada's annual conference was cancelled during 2020 in favor of a series of pre-recorded webinars on various relevant topics. This year, the CRA Roundtable was part of the pre-recorded webinars and was released in mid-November 2020. For insurance and estate practitioners, there were a number of questions and answers that should be of interest. Kim Moody, points out these questions and provides brief comments regarding their relevance to estate planning.

ROGERS ENTERPRISES (2015) INC. - TAX COURT FINDS THAT AN INCREASE IN A CAPITAL DIVIDEND ACCOUNT BALANCE IS NOT A TAX BENEFIT UNDER THE GAAR

Sanjana Bhatia, *Sun Life Financial*

Introduction

Since the General-Anti Avoidance Rule (GAAR) was enacted in 1988, only a few cases have dealt with the issue of whether there has been a "tax benefit".[1] GAAR disputes have focused more often on the third part of the test where the Crown must show misuse or abuse of the provisions of the *Income Tax Act* (the Act).[2] This is because the taxpayer usually concedes that the transactions resulted in a tax benefit.[3]

Rogers Enterprises (2015) Inc.[4] (*Rogers*) is a recent example of where the Court has held that the series of transactions the taxpayer entered into did not result in a tax benefit. As such, *Rogers* is a significant and important decision because it adds to the GAAR jurisprudence that an increase in a tax attribute is not a tax benefit under the GAAR. This article discusses *Rogers,* which was decided in favour of the taxpayer.

Statutory Context and Background

Before discussing *Rogers*, it is helpful to outline briefly the relevant legislation, including the GAAR, as well as the 2016 changes to the capital dividend account (CDA) rules.

(a) *The GAAR Test*

The GAAR scheme is set out in subsections 245(1) to (5) of the Act and requires that three questions be decided:

(1) Was there a tax benefit?
(2) Was there an "avoidance transaction" or a "series of transactions"?[5]
(3) Was there misuse or abuse?

The burden is on the taxpayer to refute (1)-(2), and on the Minister of National Revenue (Minister) to establish (3).[6]

If a Court concludes there is no tax benefit resulting from a transaction or part of a series of transactions, then the GAAR will not apply. If there is a tax benefit, a Court will have to determine whether the transaction or series of transactions were abusive. If the Court determines that there is a misuse or an abuse of the Act's provisions, then the GAAR will apply. If the GAAR applies, the Minister substitutes the tax result that she determines should have occurred for the one the taxpayer asserted.

(b) *The CDA and the 2016 Changes to the CDA*

The CDA, defined in subsection 89(1), is a notional account available for private corporations that is used to pay out tax-free capital dividends under subsection 83(2) of the Act.[7] Although the CDA definition is exceedingly complex, it includes, among other things, most or all of the life insurance death benefit proceeds that a corporation receives as a beneficiary of the policy. Prior to 2016, if a corporation was the owner and the beneficiary of the policy, the corporation was required to deduct the policy's adjusted cost basis (ACB) from the life insurance proceeds before the corporation could add those proceeds to its CDA.[8]

The federal government amended the CDA definition (effective for deaths occurring after March 21, 2016) to ensure that the ACB of the insurance policy would reduce the CDA credit of a corporate beneficiary, even where that beneficiary was not the owner of the policy.[9] Before this legislative change, the Canada Revenue Agency (CRA) consistently took the view that, if the purpose of separating the ownership and beneficiary of a policy was to maximize the CDA, it would seek to invoke the GAAR. In fact, the CRA's position was that it would review any situation involving a corporate group where life insurance proceeds included in a corporation's CDA were not reduced by the ACB of the policy.[10]

Facts in *Rogers*

The late Mr. Edward Samuel (Ted) Rogers was the President and Chief Executive Officer of Rogers Communications Inc., a Canadian public company in the Rogers corporate group (the RPC Group). From 1982 to 1991, private corporations in the RPC group and a family trust purchased twelve life insurance policies on the life of Mr. Rogers. More specifically, E.S.R. Limited (ESRL) was the owner (that is, the policyholder) and beneficiary of ten of the policies, and the 1984 Rogers Ownership Trust (1984 Trust) was the policyholder of the other two policies.

In 2005, in the course of a significant corporate reorganization of the RPC Group, CGESR Limited (CGESR) became the beneficiary of the policies. ESRL and the 1984 Trust remained the policyholders and continued to pay the premiums on their respective policies.

Mr. Rogers passed away in December 2008. CGESR credited the full amount of the insurance death benefit proceeds to its CDA (~ $102 million) and did not deduct the ACB of the policies (~ $42 million). CGESR relied on its understanding of the law as per the pre-2016 rules.

In 2009, CGESR paid capital dividends to two companies (ESRIL 98 and CGESR 2009) who were CGESR's shareholders. Each of these companies added the capital dividends they received from CGESR to their CDAs. CGESR 2009 paid a capital dividend to the 1995 Trust (another family trust in the RPC group). The total capital dividends paid up to this point were ~ $10 million.

Later in 2009, CGESR redeemed ESRIL 98's shares for ~ $92 million and elected the dividend on the redemption to be a capital dividend under subsection 83(2) of the Act. ESRIL 98 added the capital dividend it received to its CDA. ESRIL 98 paid ~ $50 million in capital dividends to its shareholder, ESRIL (the policyholder of ten of the twelve policies). ESRIL 98 did not pay out any further capital dividends and thus its CDA balance remained at ~ $42 million. The taxpayer, Rogers Enterprises (2015) Inc., became the successor by amalgamation of CGESR and ESRIL 98.

In 2015, the CRA issued the taxpayer a notice of determination[11] on the basis that the GAAR applied to the series of transactions, and reduced the taxpayer's CDA by the ACB of the policies. The taxpayer appealed the CRA's decision to the Tax Court of Canada (TCC).

The TCC's Decision

The taxpayer conceded that there was a series of transactions. However, it maintained that there was no tax benefit. In addition, even if the series had resulted in a tax benefit, none of the transactions in the series were abusive. The taxpayer also conceded that, if the series resulted in a tax benefit, the primary purpose of the transactions making up the series was to obtain the tax benefit. However, the taxpayer disputed that there was a tax benefit, and also disputed that the transactions were abusive.

Therefore, the remaining issues were: 1) was there a tax benefit and, 2) was there misuse and abuse of the Act?

(a) Was There a Tax Benefit?

The Crown argued that there were four tax benefits in this case:

- The increase in the CDAs of CGESR and ESRIL 98;
- The reduction in income as a result of the election under subsection 83(2) to pay the dividends as capital dividends;
- The avoidance of Part III tax with respect to the dividends; and,
- The avoidance of Part I tax by ESRIL 98's ultimate shareholders.

Subsection 245(1) defines a "tax benefit" as "a reduction, avoidance, or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act…"

The CDA Increases

Justice Sommerfeldt rejected the Crown's first argument, that the increase in the taxpayer's CDA was a tax benefit, for five main reasons. First, he disagreed with the Crown's interpretation that the increase in the CDA balance fell within the phrase "an increase in… [an] other amount under this Act." Instead, he held that the correct grammatical interpretation of a tax benefit is an increase in a refund of tax or a refund of another amount.

Second, Justice Sommerfeldt held that the *Explanatory Notes*[12] suggest that a tax benefit is intended to refer to amounts that are payable or refundable under the Act, such as interest, penalties and source deductions. The *Explanatory Notes* did not mean to capture an increase in a tax attribute like a CDA balance.

Third, a tax benefit is limited to refunds of tax or other amounts payable under the Act. The CDA is not an amount payable.

Fourth, Justice Sommerfeldt held that it does not seem reasonable to view increases in all amounts under the Act as tax benefits. For example, it does not make sense that an increase in amounts such as income or profits would constitute a tax benefit.

Fifth, the phrase, "other amount under this Act" in the definition of tax benefit refers to an amount that could be refunded, such as refundable credits. An increase in a CDA is not a refundable amount.

The Reduction in Income

Justice Sommerfeldt held that the taxpayer treating the dividends as capital dividends did not result in any change in tax. This is because the taxpayer paid the dividends to corporate shareholders who could have deducted them in any event under subsection 112(1). (Subsection 112(1) allows inter-corporate dividends to be received tax-free. The dividend is not taxed until it reaches the individual shareholder). As such, the capital dividend treatment did not result in any reduction of tax, and therefore could not be a tax benefit.

The Avoidance of Part III Tax

Justice Sommerfeldt dealt with the issue of whether a tax benefit existed by comparison with an alternative arrangement.[13] The comparison in this case would be whether ESRIL 98 avoided Part III tax that would have applied to an excess capital dividend election in relation to its capital dividend of ~ $50 million. He concluded that there was no tax benefit because ESRIL 98 had a sufficient balance in its CDA to cover the amount of the dividend (even if the CRA's position that the CDA was only ~ $50 million, not ~ $92 million, was correct).

The Avoidance of Part I Tax

Finally, Justice Sommerfeldt concluded that an increase in a tax attribute (the CDA in this case) does not result in a reduction, avoidance or deferral of tax. He concluded that, "…the future reduction of tax under Part I of the *ITA* by the ultimate shareholders at ESRIL 98, as suggested by the Crown, is not a tax benefit at this time."[14] In other words, there is no tax benefit until the taxpayer pays capital dividends out of the increased CDA to its ultimate shareholders.

Observations

Rogers confirms that there is no tax benefit merely when a tax attribute is increased, or income is reduced. There must be an actual reduction in tax payable or an increase in a refund of an amount that was payable under the Act. This finding is consistent with other case law. For example, in *Perry Wild*[15] (and relied on by Justice Sommerfeldt in *Rogers*), the Federal Court of Appeal (FCA) concluded that the transaction that resulted in the increased paid-up capital (PUC) in respect of certain shares did not result in a tax benefit and that section 84.1 was not abused. Also, in *Copthorne* the Court recognized that the mere preservation of PUC did not result in a tax benefit.[16] The tax benefit was realized only when the shares were redeemed and the PUC was used to reduce the Canadian withholding tax on the deemed dividend on the redemption transaction.[17]

Similarly, in *Gladwin Realty*,[18] the FCA recently held that an increase in a tax attribute like the CDA balance cannot be a tax benefit by itself. The tax benefit does not arise until tax is actually paid out to a recipient capable of benefiting from its tax-free character. Although some capital dividends were paid, they were paid to corporate shareholders who could have deducted regular taxable dividends under subsection 112(1) in any event. The Court's conclusion in *Gladwin Realty*, that an increase in the taxpayer's CDA balance alone cannot be a tax benefit until an amount is paid out to a shareholder who benefits from the tax-free nature of the capital dividend, is consistent with its prior decision in *Perry Wild*. Also, in *OSFC Holdings Ltd. v. Canada,*[19] (OSFC) the FCA concluded that the pre-packaging of tax losses did not result in a tax benefit. Rather, the tax benefit accrued only when the taxpayer acquired its partnership interest and became entitled to share in the partnership's loss.

Copthorne, Gladwin Realty, OSFC and *Perry Wild* are all solid authorities supporting the proposition that an increase to a tax balance alone cannot be a tax benefit within the meaning of subsection 245(1). These cases, with the addition of *Rogers*, appear to settle the issue that an increase to a tax attribute (such as a CDA) alone cannot be a tax benefit within the meaning of subsection 245(1).[20]

(b) Was There Misuse and Abuse of the ITA?

Justice Sommerfeldt's conclusion that there was no tax benefit was sufficient to allow the taxpayer's appeal and dispose of the case. However, he proceeded to analyze whether the series of transactions was abusive. For this purpose, he analyzed the underlying rationale (the object, spirit and purpose) of the key provisions in the CDA regime. He also conducted a textual, contextual, and purposive analysis of those provisions that would reduce the proceeds of a life insurance policy by the ACB of the policy.[21]

<u>The Rationale</u>

After reviewing the legislative history of the treatment of life insurance policy proceeds, Justice Sommerfeldt concluded that there is no broader "underlying rationale" to the provisions. He rejected the Crown's argument that the rationale required a CDA reduction where the recipient of the life insurance proceeds is not the policyholder.

The Crown also submitted that the *Explanatory Notes* released by the Department of Finance on October 21, 2016 support its argument that the amendments were made to make an existing legislative purpose more explicit. Justice Sommerfeldt dismissed the Crown's evidence of the Explanatory Notes as self-serving and ambiguous.

<u>The Text</u>

Justice Sommerfeldt then examined the text of the CDA provision. He noted that the provision initially used the phrase, "the adjusted cost basis of the policy…to the corporation" in the CDA definition from 1977 to 1986, and then subsequently used the phrase, "the adjusted cost basis…of a policy…to the corporation" from 1986 to 2016. He concluded that the relevant words must mean the ACB of the policy to the corporation, which supported the taxpayer's position. In affirming the textual approach, Justice Sommerfeldt stated that "…Parliament said what it meant to say."[22]

<u>The Context</u>

With respect to the context, Justice Sommerfeldt concluded that Parliament was deliberate and intentional in describing the ACB of a life insurance policy by reference to a particular person. For example, he refers to other provisions of the Act dealing with life insurance, and ascertains that they sometimes refer to the ACB to the corporation, sometimes to the ACB to the taxpayer, and sometimes to the ACB to the policyholder. Therefore, the contextual analysis indicates that in 2008, we were to use the ACB to the corporation that received the policy proceeds. In other words, the context of the Act supports the textual meaning.

<u>The Purpose</u>

Justice Sommerfeldt found that the Crown was inconsistent as to the purpose of subparagraph (d)(iii) in the definition of "capital dividend account" under subsection 89(1), as it read in 2008 and 2009. The Crown's reasons as to why the ACB needed to be deducted from the policy proceeds in order for a corporate beneficiary to credit its CDA was also unclear. For example, the Crown agreed in its written examination for discovery that the purpose behind excluding the ACB from the capital dividend account was "to limit the amount of retained earnings that a corporation can distribute to a shareholder on a tax-free basis through the purchase of a life insurance contact and the use of CDA account."[23] However, in a written statement during the trial, the Crown stated that, "if amounts had been distributed by the corporation to the shareholder personally to personally pay for the life insurance policy, such amounts would have been taxable to the shareholders".[24]

Because of the Crown's lack of clarity, Justice Sommerfeldt was not satisfied that the Crown had adequately explained the provision, and concluded that the Crown had not met its onus under subsection 245(4) to establish clearly the object, spirit and purpose of the relevant provisions. Accordingly, the series of transactions that resulted in the addition of the full amount of the death benefit proceeds of the policy (not reduced by the premiums paid under the policy) was not abusive.[25] Citing *Copthorne*, Justice Sommerfeldt also concluded that "…this is one of those, perhaps rare, situations where the underlying rationale of the Reduction Provision in 2008 and 2009 was no broader than the text itself."[26]

Observations

The separation of the policyholder (ESRL or the 1984 Trust) and the beneficiary (CGESR) of the policies was entirely consistent with the longstanding practice, the terms of the life insurance policies and the scheme of the Act, both as it existed at the time of Mr. Rogers' death and at present. Both the previous and amended definition of the CDA reflect that a corporate recipient of a life insurance policy may not be the beneficiary.[27] Because the life insurance proceeds received by CGESR were received tax free, it was entirely consistent with the policy underlying the CDA that the full amount of the proceeds was added to CGESR's CDA so that CGESR could distribute those amounts to its shareholders as a capital dividend. This maintained the tax-free status of the life insurance proceeds,[28] consistent with the purpose of the CDA scheme. Adding the full amount of the life insurance proceeds to CGESR's CDA (without any ACB deduction) was in accordance with the clear text, context and purpose of the CDA provisions. Justice Sommerfeldt correctly concluded that it was not abusive.

The CRA's Interpretation of ACB and No Pro-Rating of the ACB

Beyond *Rogers,* it is also important to note that the CRA's views regarding the ACB of the policy under subparagraph 89(1)(d)(iii) leads to an unfair result. For example, the CRA's interpretation is that where there are multiple beneficiaries, the CDA will be reduced by the *full* ACB of the policyholder's interest in the policy for each beneficiary and cannot be prorated.[29] The insurance industry has brought this issue of double counting the ACB to the attention of Finance.

Conclusion

The Minister has decided not to appeal *Rogers*. The Minister could challenge this transaction in the future, however, if the taxpayer pays out the ~ $42 million of capital dividends to its individual shareholders on the basis that there is now a tax benefit resulting from a series of transactions. However, the abuse test will remain a difficult obstacle for the Minister because another Tax Court judge could agree with Justice Sommerfeldt's findings (even though his comments on abuse were *obiter dicta*).

In any event, *Rogers* is an important decision because it adds to the GAAR jurisprudence that an increase in a tax attribute (the CDA in this case) is not a tax benefit. As well, from a GAAR perspective, it is also recognition that the text of a provision is sometimes conclusive. *Rogers* is also a unique case because it is rare that the TCC rules on issues involving policyholder insurance taxation and the GAAR.[30]

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[1] See, for example, *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 ("*Copthorne*"); *1245989 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114 (*Perry Wild*); *Gladwin Realty Corporation v. Canada*, 2020 FCA 142 (*Gladwin Realty*); *Canada v. 594710 British Columbia Ltd.*, 2018 FCA 166; *Univar Canada Ltd. v. The Queen*, 2005 TCC 723.

[2] *Income Tax Act*, (R.S.C., 1985, c. 1 (5th Supp.) as amended) (the Act). Unless otherwise stated, all statutory references in this article are to the Act.

[3] See, for example, *Canada v. MIL (Investments) S.A.*, 2007 FCA 236; *Canada v. Mackay*, 2008 FCA 105; *Canada v. Landrus*, 2009 FCA 113; *Swirsky v. Canada*, 2014 FCA 36; *Canada v. Spruce Credit Union*, 2014 FCA 143; *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2020 FCA 43 (leave to appeal to the Supreme Court of Canada granted August 6, 2020); *McMullen v. The Queen*, 2007 TCC 16; *McClarty Family Trust v. The Queen*, 2012 TCC 80; *Golini v. The Queen*, 2016 TCC 174.

[4] 2020 TCC 92.

[5] Under subsection 245(3) of the Act, a transaction will be an avoidance transaction if it results in a tax benefit, and is not undertaken primarily for a *bona fide* non-tax purpose. An avoidance transaction may operate alone to produce a tax benefit, or may operate as part of a series of transactions to produce a tax benefit. Subsection 248(10) of the Act extends the meaning of "series of transactions" to include any related transactions or events completed "in contemplation of" the series.

[6] *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 (*Canada Trustco*) at paragraphs 66-67.

[7] The concept of the capital dividend was introduced in 1972 as part of the system to ensure the integration of corporate and personal tax on capital gains realized by Canadian private corporations.

[8] Before the 2016 legislative changes, subparagraph(d)(iii) in the definition of "capital dividend account" under subsection 89(1) read as follows: "(d)(iiii) the adjusted cost basis (within the meaning assigned by subsection 148(9)) of a policy referred to in subparagraph (i) or (ii) *to the corporation* immediately before the death…" (Emphasis added).

[9] Subparagraph (d)(iii) in the definition of "capital dividend account" under subsection 89(1) was amended by the 2016 Budget second bill, effective December 15, 2016 to read as follows: "(d)(iii) the "adjusted cost basis" (in this paragraph as defined in subsection 148(9)), immediately before the death, of

(A) if the death occurs before March 22, 2016, a policy referred to in subparagraph (i) or (ii) *to the corporation*, and

(B) if the death occurs after March 21, 2016, a *policyholder's interest* in a policy referred to in subparagraph (i) or (ii) (Emphasis added).

[10] See, for example, CRA Document No. 2010-0371901C6, "Avantage à l'actionnaire, assurance-vie," October 8, 2010; CRA Document No. 9824645, "Capital Dividend Account, December 15, 1998; CRA Document No. 9908430, "CALU Conference May 1999," Question 3, May 1, 1999; CRA Document No. 2004-0065461C6, "Corporate-Owned Life Insurance," May 4, 2004.

[11] Under subsection 152(1.11) of the Act.

[12] Michael H. Wilson (Minister of Finance), *Explanatory Notes to Legislation Relating to Income Tax* (Department of Finance: Ottawa, June 1988), p. 462.

[13] The existence of a tax benefit can be established by comparing the taxpayer's situation with an alternative arrangement that could reasonably have been carried out but for the existence of the tax benefit. (*Canada Trustco*, *supra* note 6 at paragraph 20).

[14] *Supra* note 4 at paragraph 49.

[15] *Supra* note 1.

[16] *Copthorne, supra* note 1.

[17] See also *Fiducie financière Satoma v. Canada*, 2018 FCA 74, a case involving the application of the attribution rules under s. 75(2), where the taxpayer (a trust) unsuccessfully argued that there was no tax benefit until a tax-free distribution was made by the trust. And, *2763478 Canada Inc. v. Canada*, 2018 FCA 209 where the Court rejected the taxpayer's argument that a future transaction or event and its tax consequence must be considered in determining whether a tax benefit had been realized.

[18] *Supra* note 1.

[19] 2001 FCA 260.

[20] *Canada v. Bank of Montreal* (2020 FCA 82) is also instructive. In this case, the FCA affirmed the TCC's decision that the GAAR did not apply because the transactions did not result in any tax benefit. More specifically on the facts, subsection 112(3.1) would not have applied in the taxpayer's double dip financing tower structure even if the Nova Scotia Unlimited Liability Company had not created two classes of shares and paid dividends only on the preferred shares.

[21] With respect to the abuse test, the onus is on the Crown to show that there has been an abuse of the object, spirit, or purpose of the provisions relied upon by the taxpayer. The Courts must then conduct a "textual, contextual and purposive analysis of the provisions giving rise to tax benefit, in order to determine why they were put in place and why the benefit was conferred". (*Canada Trustco*, *supra* note 6).
[22] *Supra* note 4 at paragraph 117.
[23] An examination for discovery is a pre-trial procedure meant to narrow the scope of the issues between litigants, clarify their positions, and obtain admissions. Overall, its purpose is to help the parties settle their dispute, if possible, or reduce the length and expense of a trial if a settlement is not possible. Written or oral answers given at an examination for discovery are made under oath, just as if they were made at trial, and are binding on the party making them.
[24] *Supra* note 4 at paragraph 127.
[25] Justice Sommerfeldt's finding is consistent with *Canada Trustco* (*supra* note 6), that if the abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.
[26] *Supra* note 4 at paragraph 131.
[27] *Supra* notes 8 and 9.
[28] Life insurance proceeds are tax-free, whether they are received by an individual, corporation, trust or other entity (subparagraph 39(1)(a)(iii) of the Act).
[29] CRA Document No. 2018-0745811C6, "CALU 2018 Q2 – CDA credit-joint ownership," May 8, 2018 and CRA Document No. 2017-0690311C6, "CLHIA 2017 – Q1 CDA," May 18, 2017.
[30] See also *Golini*, *supra* note 3 where the TCC held that the GAAR applied to a life insurance leveraging transaction.

DOES THE CANADA REVENUE AGENCY HAVE THE POWER TO SEIZE LIFE INSURANCE PROCEEDS TO SATISFY THE DECEASED'S TAX LIABILITY?

Glenn R. Stephens, *PPI Advisory*

1. Introduction

It is well understood that life insurance policies provide a level of creditor protection, primarily under each province's *Insurance Act*, that is not available to other financial products. Creditor protection is available in the common law provinces where there is a defined family relationship between the insured person and the beneficiary (in Quebec the applicable relationship is that between the policy owner and beneficiary).[1] Protection is also available where a beneficiary is designated irrevocably.[2] When paid to a designated beneficiary, the death benefit proceeds themselves will not be subject to the deceased's creditors.[3]

This article will consider whether life insurance also enjoys protection from the broad collection powers provided to the Canada Revenue Agency ("CRA") under section 160 of the *Income Tax Act* (Canada) (the "Act")[4]. This section provides the CRA with the ability to seize funds or other property transferred by a tax debtor to a non-arm's length party. Where this section applies, the transferee becomes jointly and severally liable with the tax debtor for the latter's tax liability. The intent of this provision is clear: to prevent a taxpayer from avoiding the payment of tax liability through the transfer of property, which would otherwise be subject to CRA claims, to a non-arm's length person.

The applicability of section 160 has been considered in a number of cases that will be addressed below. The particular focus of this article is whether the powers granted under this section allow the CRA to seize insurance death benefit proceeds paid to a non-arm's length party under a policy insuring the life of the tax debtor. Fortunately for the insurance industry and its clients, and as discussed below, there are strong arguments to suggest that the CRA may be unable to do so.[5] This further reinforces the position of life insurance as financial tool with unique creditor protection features.

2. The Legislative Language and Scope

Section 160 applies where an individual has "transferred property, either directly or indirectly, by means of a trust or by any means whatever" to any one of the following:

- The person's spouse or common-law partner, or to someone who has since become the person's spouse or common-law partner;
- A person who was under the age of eighteen; or
- A person with whom the individual did not deal at arm's length.

Where such a transfer occurs, the transferor and transferee are jointly and severally liable for the outstanding income tax obligations of the transferor. The following are some key aspects that define the scope of section 160:

- The transferee's liability is limited to the fair market value of the property transferred less any consideration paid by the transferee.

- The section applies whether or not the transferor was intending to avoid payment of the tax and whether or not the transferee was aware of the debt.
- Section 160 applies to transfers taking place on or after May 1, 1951 and contains no limitation period.

3. Overview of Case Law

It is well beyond the scope of this article to thoroughly review the extensive list of cases that have been decided under section 160. The following are some brief examples:

- The rule applies where a debtor corporation pays a dividend to a non-arm's length shareholder.[6]
- It also applies where a debtor corporation confers a benefit on a shareholder under subsection 15(1) of the Act.[7]
- In one case, the rule applied when a tax debtor paid expenses towards her child's wedding. This was considered to be a transfer as the child personally benefited from the transferred funds.[8]

The list of decided cases is extremely long, and the decisions clearly indicate the wide reach of section 160.

There have been many cases where the CRA was successful in using section 160 to pursue named beneficiaries under RRSPs and other registered plans held by deceased tax debtors. For example, in the 2015 Tax Court of Canada decision in *Kuchta v. The Queen*[9], the deceased had named his wife as beneficiary of his $300,000 RRSP. The CRA was successful in arguing that the RRSP funds otherwise payable to the beneficiary were available to satisfy the deceased's tax liability.

A similar finding was made by the Tax Court in the 2020 case of *Dreger v. The Queen*[10], where amounts paid to the deceased's daughters as beneficiaries of his Life Income Fund (purchased through the deceased's RRIF) were found to be accessible to the CRA to pay his tax debt. The daughters were unsuccessful despite their creative argument that they were no longer in a non-arm's length relationship with their father due to his death.

4. Potential Impact on Life Insurance Payments

The above commentary reflects the fact that section 160 can apply in a wide range of circumstances, but will it apply to the payment of life insurance proceeds? Fortunately for the life insurance industry and its clients, there appear to be many good arguments that insurance proceeds may not be similarly exposed.

1. Does the Payment of Life Insurance Death Benefit Proceeds Constitute a "Transfer"?

Support for the exclusion of life insurance death benefit proceeds from these rules begins with an examination of the relevant wording in section 160, which presupposes a "transfer" of property from one person to another. If there is no transfer, the rules do not apply. The payment of life insurance death benefit proceeds by an intermediary (the insurance company) does not constitute a transfer of property directly from the deceased to the beneficiary. It is distinguishable from cases where, for example, pre-existing funds in a registered plan are paid to a named beneficiary on the plan holder's death.

One potential caveat relates to cash values that may form part of the death benefit proceeds in excess of the policy's face amount. This is seen, for example, in certain "face plus" universal life policies. Could the CRA argue that the portion of the proceeds representing the cash value existing prior to death, as distinct from the actual insurance portion of the proceeds, is in a separate category and more likely to be subject to section 160? There appear to be no decided cases or CRA statements dealing with this issue, but it is worth bearing in mind.

2. Insurance-related Case Law

There is also some helpful case law in support of the proposition that section 160 does not apply to life insurance proceeds. In the 2010 Tax Court decision in *Nguyen v. The Queen*,[11] the deceased's wife was named beneficiary of her husband's insurance policy, but her daughter mistakenly arranged for the funds to be deposited to the estate's bank account. The CRA argued that the use of the funds by the widow constituted a transfer to her within the meaning of section 160, and that the money was therefore available to satisfy the deceased's tax debts. The Court did not agree, finding that the deposit of the funds into an estate bank account was an error and that the funds belonged to the widow in their entirety.

A 2013 decision of the Tax Court in *Higgins v. The Queen*[12] lends even more support to the argument that section 160 does not apply to insurance death benefit proceeds. This case involved a registered segregated fund, the proceeds of which were paid to the two daughters of the deceased. The CRA argued that the section applied because the beneficiary designation was revocable, i.e. Mr. Higgins had complete control over the funds and could have withdrawn them during his lifetime and paid them to his daughters. This would have constituted a direct transfer within the meaning of section 160. In the CRA's mind, the payment of the death benefit to the daughters was an indirect transfer of the kind also contemplated in the section.

The Court did not agree with the CRA's position. In its decision, the Court noted that a segregated fund is a hybrid investment/insurance product, but that its "overarching" feature was the life insurance component. The Court also stated that the CRA's argument regarding the revocability of the designation was a "red herring" that had no bearing on whether or not a transfer had taken place. The funds payable to the beneficiaries were therefore outside of the reach of the CRA.

3. Payment of Insurance Death Benefit Proceeds where the Estate is Beneficiary

As the above discussion indicates, the requirement that there be a transfer of property for section 160 to apply should relieve the beneficiary of insurance death benefit proceeds from any obligations under these rules. The same cannot be said, however, where the tax debtor's estate is named beneficiary of the insurance policy, and where the funds are subsequently gifted to a beneficiary of the estate. It is likely that the beneficiary in that case would be liable under section 160, as the estate would be indebted to the CRA and the estate beneficiary would be considered a non-arm's length transferee of the funds.

4. Applicability of Section 160 where Insurance Death Benefit Proceeds are paid to a Corporation

There do not appear to have been any court decisions dealing with applicability of section 160 in situations involving the payment of insurance death benefit proceeds in a corporate setting. It seems clear that if a corporation is the owner and beneficiary of a policy on the life of a key shareholder, for example, the proceeds will be subject to the corporation's creditors, including the CRA. There are however situations where a policy is owned by one corporation, and a second corporation is the beneficiary. Pursuant to the above commentary, and subject to the comments that follow under the next heading, it seems unlikely that the CRA will be able to use section 160 to seize proceeds paid to the beneficiary corporation in this example.

Careful planning is required when decisions must be paid regarding policy ownership and beneficiary designations in a corporate group. Income tax considerations, which are not being addressed in this article, are often the key factors, with creditor protection a secondary consideration.

5. "Deathbed" Change of Beneficiary Designation

Consider the example of a terminally ill individual tax debtor who changes the beneficiary designation on his or her insurance policy from the estate to a named beneficiary. Similarly, a debtor corporation that is the owner and beneficiary of policy on the life of its shareholder might change the designation to a family member of the shareholder immediately before the shareholder's death. Would the payment of proceeds in these circumstances more likely constitute a transfer within the meaning of section 160 and potentially subject the proceeds to seizure by the CRA?

There are no cases or CRA statements dealing with this issue, but it is easy to imagine the CRA attempting to apply section 160 in circumstances such as this. It is difficult to speculate, but the likelihood of the CRA succeeding may be greater in a case where there is a "deathbed" change in a beneficiary designation, than in one where a beneficiary designation is simply part of longer term, prudent planning.

6. Conclusion

Section 160 is a longstanding and powerful tool in the hands of the CRA that prevents taxpayers from avoiding their obligations through non-arm's length transfers and similar transactions. The actual wording of the section, however, provides a strong argument that insurance death benefit proceeds paid to a named beneficiary are excluded from this rule. This argument is fortified by the (admittedly small) number of cases that have dealt with the section's applicability to insurance payments.

This is consistent with the underlying purpose of these provisions, which is to preserve the estate of a tax debtor for the purposes of tax collection by the CRA. Death benefit proceeds paid to a named beneficiary would not have been part of the estate in any case, so in that sense the CRA is not deprived by being unable to apply the proceeds towards the deceased's tax debts.

As stated at the beginning of this article, life insurance products enjoy a degree of creditor protection that is unavailable to other types of financial instruments. As the above discussion indicates, there are strong arguments that this protection may extend beyond the usual commercial creditors to include tax debts owing to the CRA.

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[1] See for example subsection 196(2) of the *Insurance Act* (Ontario), R.S.O. 1990. C 1.8, (hereafter the "*Insurance Act*").
[2] See subsection 191(1) of the *Insurance Act*.
[3] See subsection 196(1) of the *Insurance Act*.
[4] *Income Tax Act*, (R.S.C., 1985, c. 1 (5th Supp.) as amended) (the Act). Unless otherwise stated, all statutory references in this article are to the Act.
[5] For an in-depth discussion of section 160 and its potential impact on life insurance proceeds see March 2020 CALU Report, "Can the CRA Pursue a Beneficiary of a Life Insurance Policy?" by David Rotfleisch, CPA, CA, JD.
[6] See for example *2753-1359 Quebec (Larouche)*, 2010 FCA 32.
[7] See *Parihar*, 2015 CarswellNat 430 (TCC).
[8] *Gitelman v. The Queen*, 2007 TCC 544.
[9] 2015 TCC 289.

[10] 2020 TCC 25.
[11] 2010 TCC 503.
[12] 2013 TCC 194.

STEP CANADA: CANADA REVENUE AGENCY 2020 ROUNDTABLE – QUESTIONS OF INTEREST FOR INSURANCE PLANNING

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STEP Canada's annual conference was cancelled during 2020 in favour of a series of pre-recorded webinars on various relevant topics. One of the highlights of the annual conference is its Canada Revenue Agency ("CRA") Roundtable. This year, it was part of the pre-recorded webinars and was released in mid-November 2020. For insurance and estate practitioners, there were a number of questions and answers that should be of interest. Accordingly, the purpose of this article is to point out these questions and provide brief comments. The complete questions and answers can be accessed here.

Question #5[1] – Application of Subsection 40(3.61)[2] and subsection 164(6)

Although somewhat technical, this question asked the CRA for clarification regarding a question asked during the 2012 STEP Canada CRA Roundtable[3] which discussed a situation where an estate elects under subsection 164(6) of the Act to apply a capital loss resulting from the disposition of shares of the capital stock of a corporation to the terminal T1 return of the deceased individual. The CRA noted that based on a technical reading of the provisions it is possible for a circularity issue to arise:

> *"If the estate realizes capital gains during its first taxation year, those gains must be applied against the loss on the share disposition, in accordance with the requirements of subsection 164(6), in order to determine the amount that can be carried back. Where this occurs, the application of subsection 40(3.61) will result in an amount of loss stopped pursuant to subsection 40(3.6), which in turn will reduce the amount available for the subsection 164(6) election, and the circular nature of these provisions becomes an issue."*[4]

CRA also noted that they had not seen an actual situation and that they would review the issue further on a case-by-case basis. Accordingly, the purpose of the 2020 follow-up question was to provide an example set of facts where the circularity could apply and possibly deny the entire loss for carry-back. After setting out the example facts where the circularity could possibly apply, the CRA analyzed the law surrounding this issue and stated that it has reconsidered its previous positions on this topic and noted "*…that an iterative grind of the estate's capital loss would yield a result which is contrary to the purpose of the relief provided by subsection 40(3.61).*"[5] The CRA further stated that it would not apply the law to grind available losses to nil as could have been the case with the interpretation of the law that CRA previously held. This is good news and insurance and estate planners should consider this in developing estate plans for shareholders of private corporations.

Question #7[6] – Tax on Split Income and Co-Tenancy Interests

The Tax on split income ("TOSI") rules were introduced into law effective January 1, 2018. As many estate and insurance practitioners likely realize, these rules are extremely complex and, if applicable, can have a material impact on developing an effective estate plan for individuals. TOSI applies to "split income" which, overly simplified, can include a variety of income such as dividend income, trust income, partnership income and interest income. This question posed the situation where there was a co-tenancy interest in a rental property and the relationship was not a partnership. STEP Canada wanted to know in that situation whether the rental income realized by each co-tenant might be subject to the TOSI rules. Further, would a subsequent capital gain on the disposition of the property be subject to TOSI? The CRA stated that in both situations, the rental income and the capital gain would not be split income and thus such amounts would not be subject to the TOSI regime. This answer was not unexpected since a careful reader of the law would come to the same conclusion but ultimately it is always good to get the CRA onside with positive interpretations. However, the experienced practitioner would also know that the factual and legal distinctions of a partnership relationship vs. a co-tenancy arrangement are not easily distinguishable in many cases. Should practitioners wish to plan to avoid the TOSI regime using co-tenancy arrangements vs partnerships, tread carefully and seek good legal advice.

Question #15[7] *– Subsection 164(6) Limitations*

As many insurance, tax and estate practitioners know, one of the core planning tools in planners' tool kits when dealing with shares of a private corporation held by a deceased shareholder's estate is the use of subsection 164(6) of the Act so as to mitigate potential double taxation issues when planning for the succession of those assets. However, subsection 164(6) is rather technical and is filled with restrictions and conditions that must be met in order to be effective. Given that, STEP Canada asked the following question:

The conditions to be eligible to utilize the double tax relieving provisions of subsection 164(6) are very restrictive. For example, there must be a disposition that occurs within the first taxation year of the graduated rate estate. Because of these strict requirements, practitioners have for years been concerned – and experienced the results of such concerns – that many estates may not be eligible for such planning because of the tight timelines and requirements for an actual disposition.

Would the CRA be prepared to recommend and work with the Department of Finance to offer affected taxpayers more relieving conditions to utilize subsection 164(6)? For example, perhaps an expanded 3 year limitation could be introduced along with an elective disposition rather than an actual disposition?

The CRA's answer was a bit disappointing since it stated the obvious by reminding the audience that CRA is responsible for administering the law and not developing policy or making amendments to the income tax law. Most practitioners are well aware of that. However, most practitioners are also well aware that many of the income tax amendments that are made in any given year are as a result of the CRA giving advice or pointing out technical issues to the Department of Finance. Accordingly, the spirit of the question was to see if the CRA agreed, in principle, with the fact that subsection 164(6) could be improved and expanded to provide relief. While the CRA did not explicitly provide its views on that, it did close its answer to the question by saying that it would be prepared to work with the Department of Finance should they seek their views on this issue. Practitioners should know that this issue remains a live issue and hopefully – one day – we will see extended relief in this area to provide better estate plans to be developed for shareholders of private corporations.

Question 16[8] *– Offshore Tax Informant Update*

In January 2014, the CRA introduced the Offshore Tax Informant Program ("OTIP" – program information can be accessed here) whereby people could receive financial rewards for providing tips to the CRA for possible non-compliance. In many recent federal budgets, the CRA has received significant funding increases to pursue offshore non-compliance issues by Canadians. Given the significant funding increases, numerous public statements by the CRA about such non-compliance and many think-tanks and political parties that believe offshore non-compliance is rampant, STEP Canada wanted to see if the CRA would share its success or non-success of the OTIP program. Accordingly, the following question was asked:

While the CRA provided updated statistics on this program in 2019, can the CRA provide any further updated statistics in respect of how effective this program is?

The CRA's answer was short but interesting. It stated the following:

Since the OTIP launch, there has been sustained interest in the program by potential informants. As of December 31, 2019, the OTIP has received nearly 5,500 calls of which over 1,600 have been from potential informants, received over 750 written submissions and has entered into nearly 50 contracts with informants.

In addition to what was provided previously, over 150 audits of taxpayers have been completed, nearly $60 million has been assessed of which approximately $20 million has been collected and over 300 audits of taxpayers are in progress.

Given the above, the following basic information can be gleaned:

- The OTIP program has been around 6 full years as of December 31, 2019 (the date of the above statistical reporting);
- Using basic averages, that means that the OTIP program has received on average 917 phone calls per year;
- The program has received on average 267 potential informants per year;
- The program has received on average 125 written submissions per year;
- With 150 completed audits and 300 active audits, there has been on average 75 audits per year;
- The amount of reassessed tax dollars has been $10 million per year with only $3.33 million collected on average per year;

The above basic analysis is obviously simplistic and doesn't consider possible growth and momentum in the program. However, the program has obviously yielded – so far – even less results than many practitioners predicted. What would be interesting to know is how much the program has cost to administer and how much has been paid out to informants (thus adding to the cost of the overall program). Notwithstanding, practitioners and taxpayers need to be aware of the CRA's continued interest in this space and ensure that their non-Canadian assets and income sources are properly reported and disclosed. In recent years, the CRA has shown interest in "tax promoter schemes" involving offshore insurance programs.[9] This continued interest in offshore compliance appears to suggest there will be continued interest in these insurance-based tax promoter schemes as well.

Conclusion

Although the questions highlighted are not specific to insurance related planning, they clarify issues relevant to the overall estate plan. Insurance is a useful tool in a well-crafted estate plan which considers these specific issues. STEP Canada is already well on its way to planning its 2021 CRA Roundtable. Stay tuned for more goodies later this year!

[1] #2020-0847181C6.
[2] *Income Tax Act*, (R.S.C., 1985, c. 1 (5th Supp.) as amended) (the Act). Unless otherwise stated, all statutory references in this article are to the Act.
[3] #2012-0449801C6.
[4] *Ibid*.
[5] *Supra* note 1.
[6] #2020-0837611C6.
[7]#2020-0839951C6.
[8] 2020-0839921C6.
[9] See Kevin Wark, "Tax Planning Arrangements Involving Insurance Products – Part 2" Insurance Planning Vol. XXV No.3 and "The CRA Responds – 2020 CALU Roundtable" Insurance Planning Vol. XXV No. 4.

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