

Corporate Owned Segregated Funds

Segregated funds (also referred to as individual variable insurance contracts, or IVICs) are an appropriate part of many portfolios. Individuals or corporations may own them. Furthermore, individuals may acquire them on a registered basis. The taxation of personally owned non-registered segregated funds is dealt with in considerable detail in our companion piece: *The Taxation of Non-Registered Segregated Funds (PC 6001-10-2006)*. This document focuses only on the unique tax and other considerations associated with corporate ownership. To benefit from a comprehensive understanding of segregated funds, you should read both pieces: this one and *The Taxation of Non-Registered Segregated Funds (PC 6001-10-2006)*

I. Timing of Inclusion of Allocated Income

A segregated fund is an inter vivos trust for tax purposes. Since the inter vivos trust must have a December 31st year-end, income of the trust, as calculated on a calendar year basis, will be flowed out (i.e., allocated) to the policyholder. Thus, the trustee will be sending the corporation a T3 slip (RL-16 slip in Quebec) that has been prepared on a calendar year basis.

A corporation may choose any year-end. It is not required to have a December 31st year-end. Thus, it needs to determine when to report the income allocated from the segregated fund.

The general rule when calculating trust income in a taxation year is that a beneficiary (in the case of a segregated fund, the policyholder) will include the income from the trust's taxation year that ended in that year.¹ If we look at a corporate policyholder having a June 30, 2006 taxation year, it would include income allocated to it for the segregated fund's year ending December 31, 2005.

II. Passive Character of Segregated Fund Investments

The segregated assets are generally passive investments, that is, the assets are not considered to be used in an active business. The impact is twofold: first, on the taxes payable, second on potential access to the \$500,000 lifetime capital gains exemption.

a) Calculation of Income Taxes Payable by Corporation

As with personally owned segregated funds, the characterization of the income allocated by the segregated funds remains intact. When the corporation in question is a private corporation, and the allocated income is considered passive income, the general rates of tax for active income do not apply. Instead, the special (generally higher) rates applying to investment income come into play, as does the Refundable Dividend Tax on Hand (RDTOH) mechanism.²

Note that taxable dividends from corporations resident in Canada are generally tax-free.³ However, Part IV tax equal to 33-1/3% of the dividends allocated to the corporation must be paid.⁴ The Part IV tax will be recovered when the private corporation distributes this income.⁵ \$1 of RDTOH will be recovered for every \$3 of taxable dividend that is paid.

¹ See paragraph 104(13)(a) of the *Income Tax Act (Canada)* (ITA).

² See definition of Refundable Dividend Tax on Hand (RDTOH) in subsection 129(3) of the ITA.

³ Subsection 112 of the ITA permits a deduction for taxable dividends from taxable corporations resident in Canada.

⁴ See subsection 186(1) of the ITA.

⁵ See subsection 129(1) of the ITA.

b) *Impact on \$500,000 Capital Gains Exemption*

A corporation that otherwise carries on an active business may decide to acquire segregated funds. Thus, the passive character of the segregated fund investment may limit the ability to access the \$500,000 lifetime capital gains exemption where this has not already been used.

The \$500,000 capital gains exemption is still available in respect of dispositions of shares of Canadian-controlled private corporations (CCPCs) that qualify as Qualifying Small Business Corporations (QSBCs).⁶ Shares must meet a number of tests to qualify as shares of a QSBC. These include criteria relating to what proportion of a corporation's assets (as measured on a Fair Market Value basis) can be considered to have been used in a Canadian active business at the time of the disposition of the shares, and in up to 24-months preceding the disposition of the shares. (A 90% test applies at the time of the disposition and a 50% test applies throughout the up to 24-month preceding period.)⁷

This issue is not unique to corporate-owned segregated funds. Whenever a CCPC owns investments, access to the \$500,000 capital gains exemption must be considered. Many owners of operating companies choose to hold passive investments in separate investment holding companies.

III. Beneficiary of Corporate-Owned Segregated Funds

A corporation may be the policyholder under a segregated fund contract, yet may wish to designate someone other than the corporation as a beneficiary. For example, it may seek to have the shareholder (or his or her spouse) designated as a beneficiary.

This approach would not be appropriate, as CRA would likely view this as a shareholder appropriation of corporate assets upon the actual payout at death. In these circumstances, a shareholder benefit would arise.⁸ Take care not to direct the insurer to pay any proceeds from a disposition of segregated fund units acquired by the corporation to a shareholder (or his or her spouse). Again, the shareholder appropriation rules would come into play.

(Of course, an individual (presumably the shareholder) must be designated as an annuitant, as the segregated fund contract provides for a disposition of the segregated funds units and the issuance of an annuity contract on the Annuity Commencement Date (ACD), where the ACD is based on the age of the annuitant. Furthermore, any death benefit guarantees provided for by the segregated fund contract would only come into play upon the death of the annuitant.)

IV. Capital Gains (or Losses) and Impact on the Capital Dividend Account

As stated in our companion piece (*PC 6001-10-2006*), the T3 slip (RL-16 slip in Quebec) that the corporation receives will contain all of the capital gains (or losses) that must be reported by the corporation in respect of the segregated fund contract. The capital gains (or losses) allocated to the policyholder will of course include amounts realized from sales of securities by the segregated fund and allocated to the policyholder, as well amounts realized from the disposition of any units.

As discussed in our companion piece, CRA generally views any death benefits or maturity benefits that are received as capital gains. Hence, these amounts will also be included on these slips.

Thus, a private corporation with access to the CDA mechanism will have the information it requires to make the appropriate adjustment to its Capital Dividend Account (CDA). The private corporation may add the non-taxable portion (currently 50%) of the capital gain allocated by the segregated fund to its CDA. Likewise, any non-deductible portion (currently 50%) of any capital losses allocated would also be taken

⁶ See subsection 110.6(2.1) of the ITA.

⁷ See definition of "qualifying small business corporation share" in subsection 110.6(1) of the ITA.

⁸ See subsection 15(1) of the ITA.

into account.⁹ The Canada Revenue Agency (CRA) has issued a technical interpretation confirming this treatment.¹⁰

Beneficiaries can also add life insurance death proceeds in excess of the adjusted cost basis of the policy to the CDA.¹¹ We are of the understanding that CRA does not consider an amount payable under a segregated fund policy as life insurance death proceeds for this purpose. The insurer will already have calculated all capital gains and have included these on the policyholder's T3 slip (RL-16 slip in Quebec).

For more information on the CDA, please refer to our Taxing Issues item on this topic (*The Capital Dividend Account, PC5674*). Take care not to pay a capital dividend from the CDA that has arisen from segregated fund transactions earlier than is appropriate. Let's assume that a significant death benefit was received when the annuitant died on January 1, 2006 and the corporation had a June 30, 2006 taxation year. Since the segregated fund trust's taxation year would end on December 31, 2006, and the capital gain portion of the death benefit would be included on the T3 slip (RL-16 slip in Quebec) prepared at that time, it would appear that an amount would only be added to the CDA as at December 31, 2006. Hence, capital dividends paid earlier than that date could not take into account capital gains (or losses) that the segregated fund trust would be reporting on the tax slips it issues for the 2006 calendar year.

We are not aware of any guidance issued by CRA in this regard. Taxpayers in this situation should consult their tax advisors. Excess capital dividends are subject to significant penalties.¹²

V. Impact of Proposals Relating to the New Dividend Tax Credit Mechanism

Segregated fund income will retain its character when it is allocated to a corporate policyholder, just as it does with individual policyholders. Thus, taxable dividends and capital gains will retain their character. (In the case of corporations, the gross-up does not apply to dividends. When we refer to taxable dividends, we mean the actual amount of the dividend.)

On June 29, 2006 the Department of Finance (Finance) introduced draft legislation relating to the taxation of "eligible" dividends.¹³ Under these rules, individual shareholders receiving "eligible" dividends from taxable Canadian corporations will be subject to an enhanced Dividend Tax Credit (DTC) mechanism. Finance proposes that for dividends paid after 2005, dividends qualifying and designated as "eligible dividends" will be grossed up by 45% with the (federal) DTC being calculated as 18.96% of the grossed-up dividend (or 27.5% of the actual dividend).¹⁴ (Under the current DTC regime, the gross-up rate is 25%, with the (federal) DTC being 13-1/3% of the grossed-up dividend (or 16-2/3% of the actual dividend)). Thus, the top federal tax rate will fall by approximately 5% (4% for residents of Quebec) for "eligible" dividends. The full impact of this measure will be revealed once we know how the provinces will proceed on this measure.

We anticipate that flow-through entities such as segregated funds will also be able to designate dividends as being "eligible." Thus, where a segregated fund receives "eligible" dividends (i.e., generally income from corporations resident in Canada that was subject to the general corporate tax rate (i.e., full rates), these will retain their identity when they have been designated as such and allocated to the policyholders.¹⁵

⁹ See definition of Capital Dividend Account (CDA) contained in subsection 89(1) of the ITA.

¹⁰ See Technical Interpretation # 2002-0175027 dated December 10, 2002.

¹¹ See paragraph (d) of the definition of CDA contained in subsection 89(1) of the ITA.

¹² See subsection 184(2) of the ITA.

¹³ See proposed definition of "eligible dividend" in subsection 89(1), as well as proposed subclause 82(1)(b)(ii), both included as part of *Legislative Proposals and Explanatory Notes Relating to Income Tax – Dividend Taxation* (June 29, 2006 Draft Legislation), as released June 29, 2006.

¹⁴ See proposed section 121 of the June 29, 2006 Draft Legislation.

¹⁵ See proposed definition of "eligible dividend" in subsection 89(1) of the June 29, 2006 Draft Legislation.

Let's now look at what happens to a corporate policyholder that has been allocated "eligible" dividends and wishes to distribute amounts to its shareholders. For purposes of this discussion, we will assume that the policyholder is a CCPC. Different rules apply for non-CCPCs.

A CCPC paying dividends will need to calculate a General Rate Income Pool (GRIP) at the end of the taxation year. GRIP generally includes post-2000 full rate taxable income (i.e., taxable income that has not benefited from the small business deduction but not investment income), plus "eligible" dividends received after 2005, plus certain other amounts. Thus, where the segregated fund designates dividends allocated to policyholders as "eligible" dividends, the amounts will be part of the CCPC's GRIP.¹⁶

The insurer may also have allocated investment income other than dividend income to the corporation (e.g., interest income, foreign source dividends, etc.). Under the proposed definition of GRIP, "aggregate investment income" is a deduction from taxable income in arriving at the pool.¹⁷

Under the proposed rules, a CCPC may distribute "eligible" dividends to the extent of the balance in its GRIP at the end of the taxation year. Thus, "eligible dividends" allocated by the insurer, but not other amounts allocated by the insurer, will give rise to "eligible" dividends. That is, the CCPC can pay dividends in anticipation of having a positive GRIP balance at the end of the year. Also, the CCPC can choose to pay "eligible" dividends before it pays non-eligible dividends. However, where excess dividends are paid, penalties apply.¹⁸

Practically speaking, a corporate beneficiary may not be able to anticipate the "eligible" dividends allocated to it. This information will only be available once the T3 slip (RL-16 slip in Quebec) has been issued. To avoid possible penalties, it is appropriate to pay dividends based on the GRIP at the end of the preceding year. Refer to I above for a discussion on the timing of the income inclusion. This discussion is also applicable for purposes of the GRIP calculation.

Our comments are based on draft legislation. The legislation, as actually enacted, will have to be reviewed in order to assess the impact of these rules.

VI. Probate Fee and Creditor Protection Considerations

Segregated funds consist of an insurance policy or an annuity contract. As such, policyholders may designate beneficiaries. In Common Law provinces (all provinces except Quebec), segregated funds may be exempt from seizure if the corporation designates the spouse, child or grandchild, or the mother or father of the annuitant as the beneficiary. However, as mentioned in section III of this document, this approach is not recommended. In Quebec the rule is different: when the corporation is the policyholder, the contract is always subject to seizure.

Also, while there is a potential for probate fee savings with personally owned segregated funds, this is not the case with corporate owned segregated funds. However, upon the death of the shareholder owning the shares of the corporation holding the segregated funds, only the value of his or her shareholdings enter into the calculation of the value of his or her estate.

VII. Summary

A review of tax considerations is only part of a prospective policyholder's decision process. The prospective policyholder and investment advisor should review all material (including the contract) provided by the insurer to determine whether an investment in segregated funds is appropriate.

¹⁶ See component "G" of the proposed definition of "general rate income pool" in subsection 89(1) of the June 29, 2006 Draft Legislation.

¹⁷ See component "F" of the proposed definition of "general rate income pool" in subsection 89(1) of the June 29, 2006 Draft Legislation.

¹⁸ See proposed definition of "excessive eligible dividend designation" in subsection 89(1) of the June 29, 2006 Draft Legislation.

Segregated funds offer insurance benefits (i.e., the maturity and death benefit guarantees) that make them attractive to many prospective policyholders, including corporations.

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