
VALUING A CORPORATE-OWNED ANNUITY

There are several financial strategies in the marketplace today that involve ownership of an annuity by a corporation. Sometimes, the annuity is based on the life of the shareholder, while in other cases it is based on the life of someone related to the shareholder.

The value of an annuity is a known quantity at the time of issue. However, a subsequent valuation of the corporate-owned annuity will be required any time the shares of the corporation need to be valued. Valuation of the shares would happen upon the death of a shareholder, because all capital property of an individual is deemed to be disposed of at the time of death. Since a corporate-owned annuity is an asset of the corporation, it would need to be valued as an integral part of placing a comprehensive value on the shares of the corporation.

There are two schools of thought on the valuation of an annuity. One approach is to use the definitional and deeming provisions of the federal Income Tax Act, while the alternative is to utilize common valuation principles.

The first approach uses a series of definitions and deeming provisions set out in the Income Tax Act. Subsection 70(5.3) states that for the purpose of the rules regarding deemed dispositions upon death, any life insurance policy is to be

valued at its cash surrender value. By definition, for all purposes of the Income Tax Act, an annuity contract is a life insurance policy (subsections 248(1) and 138(12)). The cash surrender value of a life annuity is generally nil, since most insurance carriers who issue life annuities do not allow commutation of the contract.

This approach has been the subject of several technical interpretation letters prepared by the CCRA in response to taxpayer inquiries. However, where one interpretation states that an annuity is not a life insurance policy, several others group annuities into the definition of life insurance. Thus, it appears that the CCRA may not have a consistent assessing practice.

The second approach uses common valuation techniques. The CCRA sets out its view on the criteria that should be considered in valuing a life insurance policy in Interpretation Bulletin IT-416R3 *Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on the Death of a Shareholder*. The CCRA suggests that the major factors that should be taken into account include:

- the cash surrender value, if any, of the policy;
- the life expectancy of the insured based on mortality tables; and
- the state of the health of the insured as it would be known to other persons.

It is important to note that such factors would be those that exist shortly before death.

While the IT bulletin does not specifically state that it also applies to life annuities, these criteria would still be applicable based on normal valuation techniques. Applying the criteria from CCRA's bulletin to a life annuity should create a value that initially begins at close to the purchase price of the annuity, but declines gradually as time passes and annuity payments are made.

Of course, where the annuity has a guarantee period, that guarantee should also be taken into account in valuing the policy.

Under either valuation approach, the value of an annuity will eventually be at or near zero. So in valuing the shares of the corporation that owns an older life annuity, a low value should be expected.

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PROFESSIONAL INCORPORATION

Recently, the Ontario government introduced legislation that allows professionals to incorporate their practices. Ontario follows Alberta and British Columbia as the third province to allow professionals to incorporate. In Ontario, a professional is defined for this purpose as a chartered accountant, certified general accountant, lawyer, social worker, veterinarian, or regulated health professional (i.e., physician, dentist, optician, nurse, midwife, dietician).

Provincial legislation should be closely reviewed for restrictions on who can be a shareholder of a professional corporation. In Ontario, for example, shareholders must be members of that particular profession. In other words, non-professionals are not permitted to be shareholders of a professional corporation. In addition, each professional body may impose restrictions on the name used by a professional corporation.

While a growing number of provinces allow professionals to incorporate, that does not automatically mean that incorporation is the right decision for a particular individual in particular circumstances. There are both benefits and drawbacks to incorporation.

The primary benefit is the potential for tax deferral. A professional can take income out of a professional corporation in the form of salary, bonus, and/or divi-

dends. But to the extent that some of the business profits are left in the corporation, they will generally attract a much lower tax rate. Incorporation provides no tax advantage to a professional who needs all of his or her income for living expenses.

The federal government, and all of the provinces, offer a lower rate of tax on a certain level of "active business income" earned by the corporation. Since this income would otherwise have been taxed at the professional's top marginal rate, a significant tax deferral can be achieved. This can be quantified by the following formula:

$$\text{Tax deferred} = (\text{top personal marginal tax rate} - \text{active business income tax rate}) \times \text{income left in the corporation, up to the active business income limit}$$

The taxes deferred will be payable when the accumulated funds are eventually drawn out of the corporation. They may also be payable upon an actual or deemed disposition of the shares. By deferring taxes, however, the professional may be able to provide a higher retirement income than would otherwise be available.

Another advantage is that the shares of the corporation may be eligible for the \$500,000 capital gains exemption. Upon

retirement, the professional could sell the shares of the professional corporation and plan to shelter some of the gain using the exemption. The professional could hope to save up to about \$115,000 in personal income taxes (\$500,000 x 50% inclusion rate x top personal marginal tax rate). (Of course, there are numerous rules that must be observed for the shares to qualify for the exemption.) Also note that the owners of a professional corporation (as defined for federal income tax purposes) cannot use the capital gains rollover mechanism when shares of that corporation are sold.

The primary disadvantages of professional incorporation are increased complexity and costs. These include setting up and maintaining the corporate structure, with a separate set of annual financial statements and tax returns. If a professional corporation is formed to be a partner of a partnership, the income eligible for the

small business tax rates may have some restrictions. Also, the partnership will have to use a December 31 fiscal period, even if it previously had a non-calendar year-end.

Generally, one of the advantages of incorporation is shelter of the shareholders' personal assets from corporate creditors. However, the provincial legislation specifically allows clients of a professional corporation to sue the shareholders of the corporation for issues related to malpractice. A lesser advantage is the fact that other types of creditors cannot sue shareholders, but rather are limited to suing the corporation.

Incorporation is new for many professionals, and the decision to incorporate must weigh all the advantages and disadvantages of the specific situation.

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CAPITAL GAINS FOR PERSONAL-USE PROPERTY

On the surface, calculating a capital gain is a fairly simple exercise. However, there are two categories of capital gain that require special attention, because of slight variations in their treatment: personal-use property and listed personal property.

Personal-use property

Personal-use property is any property that is used primarily for the personal use and

enjoyment of the taxpayer and his or her family. Also included in this definition is any debt taken back on the sale of personal-use property.

The most significant issue with respect to personal-use property is that while gains on such property are subject to tax, losses are not deductible in any fashion. The following example highlights this:

	Used Car (\$)	Boat (\$)
Proceeds of sale	4,000	6,000
Adjusted cost base	8,000	5,000
Capital gain (loss)	zero	1,000
Taxable capital gain (loss)	zero	500

In the above example, the taxpayer disposed of two personal-use assets, a used car and a boat, in the same year. While the gain on the boat creates taxable income, the loss on the car is completely ignored.

The logic of denying tax relief on such losses is that the original expenditure was not made to earn income from business or property. In other words, the decrease in value occurred through use for personal enjoyment and not an income earning exercise.

Another important provision for personal-use property is the *de minimus* rule. Under this rule, the proceeds of disposition and adjusted cost base of personal-use property are each set at a minimum of \$1,000. Application of the *de minimus* rule has the effect of eliminating small items in the calculation of a capital gain. Where both the adjusted cost base and the proceeds of sale are \$1,000 or less, the sale does not need to be reported.

Also, any gain on the first \$1,000 of proceeds remains tax free. As an example, consider a taxpayer who disposes of a piece of furniture for \$1,750 where the original cost of the property was \$600. In this case, while it would appear that the taxpayer has realized a \$1,150 capital

gain, the *de minimus* rule increases the adjusted cost base to \$1,000. After this adjustment, the taxpayer will realize a capital gain of \$750 (\$1,750 – \$1,000).

A house, cottage, condominium, or other housing unit is a personal-use property. Increases in value for years in which the property was the principal residence of the taxpayer are not subject to tax.

Listed personal property

Listed personal property is a subcategory of personal-use property. It is defined as a taxpayer's personal-use property that is a piece of art, jewellery, rare manuscript, stamp, or coin. The definition of listed personal property is very specific and does not leave room for additional inclusion of similar items.

Listed personal property is treated in a similar manner to personal-use property. The *de minimus* rule applies and any gain realized on the disposition of listed personal property is taxable. However, unlike personal-use property, losses realized on the disposition of listed personal property can be claimed against gains realized on the disposition of listed personal property in either the current year, the three prior years, or the seven subsequent years.

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