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ADVANCED LIFE DEFERRED ANNUITIES

If you own a registered retirement savings plan (RRSP), you must wind it up by the end of the year in which you turn 71.

At that point, you have the following options.

First, you can take out all the funds in one lump sum. However, since the funds will be fully included in your income in the year of withdrawal, this is usually not wise from a tax perspective. If the withdrawn amount is significant and puts you in the highest tax bracket, you may be paying 50% or more in tax, depending on your province of residence.

Second, you can transfer the funds to a registered retirement income fund (RRIF). This allows you to spread out your withdrawals over time. The RRIF rules require you to withdraw a minimum amount each year, which increases as you get older, and which is included in your income in the year of withdrawal. But since you can spread out the income over many years, the withdrawals might not put you in the highest tax bracket and thus you will likely pay less tax compared to the lump sum option.

Lastly, you can use the funds to acquire an annuity. Among other things, the annuity can be for the rest of your life, or for the rest of your life and your spouse's (or common law partner's) life. Generally, the annuity must make payments at least annually, and there are some limits as to the guaranteed term of the annuity. Similar to the RRIF option, this option can save you tax, assuming the annuity payments each year do not put you into the top tax bracket.

In the 2019 Federal Budget, the government introduced another option, which took effect as of January 1, 2020. This option

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was passed into law recently, as part of amendments made to the Income Tax Act in June 2021.

Under this option, you can transfer funds to acquire an “**advanced life deferred annuity**” (ALDA). In this case, you can defer receiving amounts from the ALDA, and therefore defer including in income such amounts, until the end of the year in which you reach any age you choose, up to age 85. This option is also available for amounts transferred from your RRIF, deferred profit sharing plan, and certain registered pension plans. (The terms of the particular plan may have to be amended to allow such transfers.)

Similar to regular annuities, the ALDA can be payable for your life or jointly for the lives of you and your spouse or partner. The amounts received each year from the ALDA are included in your income (or your spouse’s or partner’s income if you have deceased). The amounts must be paid at least annually.

However, there are monetary limits. In general terms, the amount used to acquire the ALDA in a year cannot exceed 25% of the value of the RRSP (or RRIF or other registered plan) at the end of the previous year. Furthermore, there is a lifetime limit to the amount you can use to acquire the ALDA. The lifetime limit is currently \$150,000, indexed to inflation and bumped up to the next \$10,000 increment as it passes the half-way point relative to the previous limit. For example, once the current limit is indexed and reaches \$155,000 or more, the limit will be bumped up to \$160,000. If you go over the limit, you will be subject to a penalty tax, generally equal to 1% per month times the excess over the limit.

When you die, the ALDA may provide a lump sum payment for your beneficiary under the ALDA contract. If the beneficiary is your spouse or partner, or a child or grandchild financially dependent upon you for support, the payment will be included in their income. (They may receive an offsetting deduction if they

contribute the amount to their own RRSP, RRIF, or to acquire an annuity, subject to certain conditions.) If the beneficiary is anyone else, the lump sum is included in your income in the year of death.

AMENDMENTS FOR NON-ARM’S LENGTH TRANSFERS OF PRIVATE CORPORATE SHARES

When you sell shares in your corporation, any resulting gain is normally a capital gain, half of which is included in your income as a taxable capital gain. Furthermore, if the shares are qualified small business corporation shares, or shares in a family farm or fishing corporation, you can claim the lifetime capital gains exemption in respect of the gain. The lifetime exemption is \$892,218 for 2021 for qualified small business corporation shares and indexed annually for inflation. For family farm and fishing corporations, the exempt amount is currently \$1 million. The exempt amounts of the gains are generally tax-free.

However, if you sell your shares to a family member’s corporation (“purchaser corporation”), the tax consequences could differ, or at least they did differ before the changes discussed below.

In general terms, if you sell the shares in your corporation to your family member’s corporation (“purchaser corporation”), the consideration you receive (other than shares in the purchaser corporation) in excess of the cost of your shares in your corporation may be deemed to be a dividend rather than a capital gain. (Technically, it is the consideration in excess of your cost and the “paid-up capital” of your shares, with other possible adjustments.) These rules can apply if the family member is non-arm’s length with you, which includes people like your children and grandchildren.

So what's the problem?

Under the Act, dividends are taxed more heavily than capital gains if you are in a high tax bracket. In addition, dividends do not qualify for the capital gains exemption.

The rules, and the recent amendments to those rules, are found in section 84.1 of the Act and are very technical in nature. The discussion here is more general.

Section 84.1 is meant to be an anti-avoidance rule. As noted, it can turn capital gains into deemed dividends on certain non-arm's length transfers. The provision does not apply to transfers to an arm's length corporation - for example, a corporation that is **not** related to the transferor or controlled by the transferor's family members.

Small-business lobby groups have argued that section 84.1 discriminates against individuals in terms of inter-generational transfers - for example, where they wish to sell to their children or grandchildren. A member of the federal Conservative Party decided to take action and proposed a private member's bill, which was passed with a majority of Parliament votes (the governing Liberal Party has a minority government).

The bill, Bill C-208, passed into law on June 29, 2021. It has amended section 84.1. The amendments apply where the shares sold by the transferor are qualified small business corporation shares or shares in a family farm or fishing corporation, if the purchaser corporation is controlled by the transferor's children or grandchildren who are 18 years old or older. As long as the purchaser corporation does not dispose of the shares within 60 months of the purchase, the deemed dividend rule will not apply. As a result, the gain on the initial sale by the transferor will be a capital gain and eligible for the capital gains exemption.

However, the Bill seems to reduce the capital gain exemption in such case if the qualified small business corporation (or family farm or fishing corporation) has taxable capital in excess

of \$10 million. Unfortunately, the wording in the Bill is unclear at this point, and it may need further amendments.

There are other technical changes under the Bill, not discussed here, which are beneficial for the purchasing corporation and / or children or grandchildren who control that corporation. All the changes are meant to treat these inter-generational transfers similar to transfers to unrelated third parties.

As enacted, and based on the provisions of the *Interpretation Act*, the Bill C-208 amendments are effective as of June 29, 2021. However, the Department of Finance announced that it intends to introduce new legislation that will delay the implementation of the amendments until January 1, 2022. Whether the Department is successful in this regard remains to be seen. It appears that Finance, which opposed the bill when it was considered by the House of Commons Finance Committee, is going to propose further amendments that may undermine or limit the effects of Bill C-208.

TAX-FREE TRANSFERS TO YOUR CORPORATION

Under the Income Tax Act, you are allowed to transfer property to your corporation (actually, to any taxable Canadian corporation) on a tax-free "rollover" basis. It is called a rollover because your tax cost of the property becomes your proceeds of disposition, resulting in no gain for you, and the corporation takes over your tax cost of the property - hence the tax cost basically "rolls over".

You need to receive at least one share in the corporation as consideration for the transfer. There are other conditions. The main conditions are described below.

The rule, found in section 85 of the Income Tax Act, allows you to elect an amount ("elected amount"), which becomes your proceeds of disposition. Often, you would elect an amount equal

to your tax cost of the property. But you can elect a different amount, subject to certain limits.

The election is actually a joint election between you and the corporation. The election must be filed by the earlier of your tax filing date and the corporation's tax filing date for the year of the transfer. Late elections are allowed, but typically with penalties.

Elected amount

The limits on the elected amount are as follows.

- It cannot be greater than the fair market value of the transferred property;
- It cannot be less than the fair market value of non-share consideration you receive from the corporation, if any; and
- It cannot be less than the lesser of the fair market value of the transferred property and your tax cost of the property.

The elected amount becomes your proceeds of disposition of the property transferred to the corporation. The elected amount also becomes the cost of the property for the corporation. Furthermore, the elected amount, minus the fair market value of any non-share consideration you receive from the corporation, becomes the cost of your share(s) in the corporation received on the transfer.

So if you elect at your tax cost of the property, you will have no gain and no tax payable on the transfer.

Why would you elect an amount greater than your tax cost of the property, since that will trigger a capital gain or perhaps other income inclusion? There are at least a couple of reasons. First, you may have capital losses that could offset those gains, resulting in no tax for you, but with a bumped-up cost of the property for the corporation and bumped-up cost of the shares you receive from the corporation (and thus a lower capital gain some time in the future). Second, if you transfer “qualified

small business corporation shares” or “qualified farm or fishing property” to the corporation, you may be eligible for the capital gains exemption, which would shelter your tax on the transfer, while again bumping the cost of the property for the corporation and the shares you receive back from the corporation.

Unfortunately, you normally cannot trigger a loss on the transfer by electing an amount less than the tax cost of the property (if the fair market value of the property is less than the tax cost). In particular, you cannot trigger a loss if you and the corporation are “affiliated”. For these purposes, you and the corporation will be affiliated if you or your spouse controls the corporation, either alone or together, or if you are part of an affiliated group that controls the corporation. Affiliation can also occur in other circumstances. “Control” normally means owning more than 50% of the voting shares in the corporation, although for the affiliated rules it also includes so-called *de facto* control (control in fact).

Eligible property

To qualify for the rollover, the property you transfer to the corporation must be an “eligible property”. This includes most types of depreciable property used in a business, and non-depreciable capital property, which includes things like real estate and shares in another corporation. It also includes inventory other than real estate inventory.

Example of rollover

You own all 100 shares in a private corporation (Opco). You transfer the shares to a holding corporation (Holdco) in exchange for 100 shares in Holdco and therefore own all the shares in Holdco.

The tax cost of your Opco shares was \$10,000. The fair market value of the shares is \$300,000 at the time of the transfer.

Assume you elect at \$10,000. Your proceeds will be \$10,000, resulting in no capital gain. Holdco's cost of the Opco shares is \$10,000, as is the cost of your shares in Holdco.

Deemed dividend trap

If instead you receive some non-share consideration from Holdco on the transfer of the Opco shares, you may have a deemed dividend instead of a capital gain. Generally, you will have a deemed dividend to the extent that the fair market value of the non-share consideration exceeds the greater of the paid-up capital and your tax cost of the Opco shares. (There may be some adjustments.) The paid-up capital of the Opco shares will normally reflect the after-tax amounts paid on for those shares when they were first issued.

The culprit is section 84.1, discussed in the previous article above. However, in this example, the Bill-208 amendments discussed in that article will **not** apply, so the deemed dividend will stand.

As noted, the deemed-dividend rule presents at least two potential problems. First, the highest marginal tax rates applicable to dividends are currently much higher than the highest tax rates on capital gains. Second, the deemed dividend is not eligible for the capital gains exemption.

Example of deemed dividend trap

Assume the same facts as above, except that you elect at \$210,000. As noted earlier, you might think that you can use existing capital losses to offset any capital gain, or perhaps the Opco shares can qualify for the capital gains exemption.

Your cost of the Opco shares was \$10,000, and assume that is also their paid-up capital. In addition to the 100 shares you receive in Holdco, you receive non-share consideration in the form of a \$210,000 promissory note from Holdco (which would allow you to extract that much cash from Holdco at no tax cost in the future by having it pay off the note).

In this case, you will have a \$200,000 deemed dividend (\$210,000 promissory note minus the \$10,000 amount).

The only consolation is that the deemed dividend reduces your proceeds of disposition on the transfer of the Opco shares, so you won't have a capital gain as well.

The deemed dividend rule does not apply if you are "arm's length" with Holdco, or generally if Holdco owns 10% or less of the shares in Opco on a votes and value basis (obviously, not the case in the example above).

DEDUCTIONS AND CONTINGENT AMOUNTS

In general terms, expenses incurred for the purpose of earning income from a business or a rental property are deductible in the year they are incurred if they are unconditional. Basically, this means that during the year, or as of the end of the year, you are legally obligated to pay the expense, even though it is not due and not paid until a future year. The key point is there must be no condition that requires to be fulfilled before your legal obligation to pay is absolute.

Examples

1) Jack hires a contractor to repair his building used in his business. The repairs are completed in year 1 and the contractor bills Jack at the end of year 1. The repairs are satisfactory to Jack and he is allowed to pay the bill within the first 6 months in year 2.

Since there appears to be no condition to Jack's legal obligation to pay, he should be able to deduct the repair expense in year 1 even if he pays it in year 2.

2) Assume instead that the repairs require certification by an architect or engineer. Part of Jack's expense (say, 10%) is not payable until the certification, which occurs in year 2. In this case, the 10% portion of the expense is conditional upon the certification, so that portion is deductible in year 2. The remaining portion should be deductible in year 1.

AROUND THE COURTS

Penalty for over-contribution to TFSA upheld

As our readers are likely aware, the income tax rules allow you to contribute to certain tax-deferred plans, such as registered retirement savings plans and tax-free savings accounts (TFSAs). The plans are called tax-deferred plans because the investment income earned in the plans is exempt from tax while in the plan. With an RRSP, amounts withdrawn from the plan are fully included in income (since you get a deduction when you contribute to the plan), while TFSA withdrawals are generally tax-free (since you do not get a deduction when you contribute to the plan).

The tax-deferred plans have monetary limits in terms of how much you can contribute to the plan. If you go over the limits, you may be liable for a penalty tax and interest. There are some relieving provisions, one of which was the subject of the recent *Posmyk* case.

In this case, the taxpayer overcontributed to his TFSA and the Canada Revenue Agency assessed a penalty. The taxpayer appealed to the Tax Court of Canada.

In general terms, the relieving provision that potentially applied to the taxpayer required that the over-contribution was made “as a consequence of a reasonable error”, and that he withdrew

the over-contribution from the TFSA “without delay”. One of the taxpayer’s arguments was that he did not have home internet access during the taxation years in question (his choice) and therefore only checked his email on occasion at the local library and did not receive CRA notifications about his over-contributions.

In its decision, the Tax Court was sympathetic with the taxpayer. The Court held that he withdrew the amount without delay. Unfortunately, his over-contribution was found **not** to be as a consequence of reasonable error, so that the penalty was upheld. His decision not to have internet access did not change this result. Basically, the Court was saying he was responsible for knowing the TFSA contribution limits even though he did not receive or was not aware of CRA notifications.

The lesson is learned?

If you have provided your email address to the CRA, then the CRA will **not** send you paper copies of any letters, Notices of Assessment, or other communications. You will instead get an email notice telling you to log into “My Account” to read your CRA mail. If you miss that message and don’t check “My Account” regularly, you may miss important mail and run into serious tax problems as a result!

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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