"Father, forgive them, for they do not know what they are doing"

The Department of Finance Canada and its civil servants in complete disarray (Part 2) – Section F

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F. Life insurance policies being transferred to private corporations: hundreds of millions of dollars in lost tax revenue while civil servants at the Department of Finance Canada were asleep at the wheel for 14 years — despite warnings issued by the CRA as early as 2002!

This is another example of the civil servants at the Department of Finance Canada taking their sweet time (14 years, despite unambiguous written public notices on the topic) to correct an unreasonable tax planning strategy that was well known by tax experts. In fact, most tax experts were baffled as to why in the world this strategy continued to be permitted. A strategy that was not aggressive since the *Income Tax Act* was so clear-cut on the issue. Furthermore, the Canada Revenue Agency (CRA) notified the Department of Finance Canada as early as 2002 of the inconsistency that existed.

What has happened since 2002

In May 2002, during a roundtable with the civil servants of the CRA at the annual CALU (Conference for Advanced Life Underwriting) event, a Pan-Canadian professional association of advisors from the life insurance sector, the CRA was asked the following:

What happens if an individual transfers a life insurance policy to a corporation they control and the life insurance policy has no cash surrender value but a higher fair market value (FMV)?

Notes du CQFF As an example, a Term to 100 life insurance (T100) has no cash surrender value, but its FMV can increase significantly over time. This can simply be due to the individual aging or because of a deterioration in their state of health after they purchased the life insurance policy.

To their credit, the CRA clearly answered the question at the time by stating that a corporation could then pay a monetary consideration to the policyholder that would be equal to the FMV of the policy at the date of transfer. The CRA also stated that as per paragraph 148(7) of the ITA, the individual would be deemed, for the purposes of calculating their personal income, to have disposed of the life insurance policy for an amount equal to its cash surrender value, which would be zero in this case. The CRA stated in 2002 that as a result, the **shareholder could actually withdraw money from their corporation tax-free**.

The CRA also stated that they brought this situation to the attention of the Department of Finance Canada and that the civil servants at this Department "would take this into account when reviewing life insurance taxation" (this is a meaningless sentence regularly used by these civil servants to buy time and make everyone believe they'll actually do something about the problem). This was the first major warning issued and the civil servants were notified they had to act and quickly modify the law.

The second major warning

Tax Topics number 1682 was published on June 3, 2004. Penned by the late prolific writer and attorney David Louis and by attorney Michael Goldberg from Minden Gross, this five-page newsletter detailed this (all too) generous strategy. Tax Topics is a weekly newsletter published by Wolters Kluwer and is probably the most read tax newsletter by Canadian tax experts. And it is by reading this June 2004 edition that this author quickly understood the potential impact of this legal planning strategy that made absolute no sense from a tax policy point of view. Honestly, before reading this tax newsletter, this author, along with most tax experts, accountants, and legal experts in Canada were unaware this was even possible. From 2004 to 2016, our organization described this issue in detail in written materials for our training activities. And every year since 2004, we've said that this strategy would surely be extremely short-lived because the CRA had already notified the Department of Finance Canada of this problem and that it had been a top story in the Tax Topics newsletter. Our organization also published an editorial in September 2005 in a specialized financial magazine and we explained the ins and outs of such a transfer. We added that this strategy would not last for much longer.

In every tax bill submitted (and there have been many) or federal government budget adopted since 2004, we expected changes to be made to paragraph 148(7) of the ITA. And to our immense surprise, it never happened … until the March 22, 2016 federal budget. It took them 14 years to actually get off their butts and change the law!

Hundreds and hundreds of millions of dollars in tax revenue gone

Why was this strategy so popular? It's actually quite simple. During the 2000s, a large majority of professionals were able to incorporate their company after changes were made throughout Canada to the laws and regulations governing their professions. As a result, in addition to existing SMEs where life insurance policies of shareholders of the company could be transferred (if the policies were held individually), a ton of SMEs offering professional services (accountants, lawyers, physicians, dentists, etc.) incorporated their business and transferred their assets to the new corporation … including life insurance policies with a FMV that had significantly increased since they were first purchased.

Think this has only happened a few times since 2002? You would be terribly wrong. Although we'll never know the exact figures, we are aware of a multitude of cases were this has occurred. Cases that involved amounts varying between $50,000 and $800,000, and probably even more. Keep in mind that every year thousands of tax professionals (CPAs, financial planners, tax experts) take part in training activities and symposiums across Canada. And these professionals count numerous SMEs as clients. For instance, a CPA who took part in our training activities told us a few years ago he had overseen about 50 transfers of policies with a high FMV to corporations in order to take advantage of this legal tax exemption. And this occurred throughout Canada for nearly 15 years! We are in no way blaming tax experts for explaining this strategy to clients. After all, had they not, they would have been criticized for failing to mention it to their clients.

Head-scratching questions

You are most likely wondering the same thing we are. How was this "free ride" made possible and ignored by the civil servants at the Department of Finance Canada, the supposed "**trustees of our collective wealth**"? Don't they listen to the CRA's clear recommendations? Do they not stay informed just like tax experts in the private sector do by reading the publications necessary to keep their knowledge up-to-date? This example once again shows the carelessness and sloppiness of these civil servants in the face of a strategy that was well-known by anyone with even an ounce of tax expertise. Even if the legislative change announced in 2016 included some kind of retroactive fix, the amount of money governments lost in tax revenue is simply colossal… And taxpayers are expected to tolerate this? "*Father, forgive them, for they do not know what they are doing*"