

currently required to pay tax owing within 90 days following their year-end.

- 5) The current \$40,000 basic exemption from alternative minimum tax will no longer apply to testamentary trusts.
- 6) Testamentary trusts will be required to use a calendar year-end.
- 7) Testamentary trusts will be subject to Part XII.2 tax. Currently, Part XII.2 tax does not apply to testamentary trusts.
- 8) To qualify as personal trusts, testamentary trusts will be required to meet the same conditions as inter vivos trusts. Currently, testamentary trusts automatically qualify as personal trusts, even if the beneficial

interest is purchased for consideration.

- 9) Inter vivos trusts are required to recognize investment tax credits in the trust, as opposed to making them available to their beneficiaries. This regime will be extended to testamentary trusts.
- 10) A number of tax administration rules will no longer be extended to testamentary trusts, including the time period for filing objections, obtaining refunds for overpayment of tax, and requesting reassessments and determinations.

The members of the STEP working group are as follows:
Rachel Blumenfeld, *Miller Thomson LLP*; Pamela Cross, *Borden Ladner Gervais LLP*; Kathleen Cunningham, *Trust*

and Estate Technical Committee: Leanne Kaufman, *RBC Wealth Management*; Tony Lalonde, *Scotia Private Client Group*; Sian Matthews; Kim Moody, *Moodys Tax Advisors*; Hugo Patenaude, *Fasken Martineau DuMoulin LLP*; David Stevens (co-chair), *Gowling Lafleur Henderson LLP*; Henry Visser (co-chair), *McInnes Cooper*

STEP members who have comments or suggestions that they would like the STEP working group to consider in preparing the STEP submission are invited to contact David Stevens (david.stevens@gowlings.com) and Henry Visser (henry.visser@mcinnescooper.com), who are co-chairing the working group. ■

2013 Federal Budget 10/8 Draft Legislation

PETER EVERETT

*Vice-President, Planning and Business Development, PPI;
Member, STEP Toronto*

Summary

On October 15, 2013, the Department of Finance tabled a notice of ways and means motion (NWMM) to implement the remaining tax measures announced in the March 21, 2013 federal budget. The draft legislation includes new rules for the treatment of certain leveraged life insurance arrangements, which it refers to as "10/8 policies." The legislation will eliminate the tax benefits associated with 10/8 policies after 2013. (The NWMM also includes the final legislation relating to leveraged insured annuities, which are not discussed in this article.)

10/8 Background

In 10/8 arrangements, policyholders deposit funds into life insurance poli-

cies over and above the premium payable for mortality coverage. Commonly, these policies are assigned as

rower. An ancillary benefit for policyholders is an increase in the capital dividend account (CDA) of a private

...the insurer credits the additional funds deposited in a policy's designated collateral account with a return that is 2 percent less than the interest rate charged on the loan.

collateral security to the life insurer in its capacity as a lender that makes loan advances to policyholders on the basis of the cash surrender value of their policies.

Loan advances have a fixed rate of interest. Provided that the advances are used for purposes that conform to the requirements of paragraphs 20(1)(c) and (e.2) of the *Income Tax Act*, the interest and a portion of the premium paid for the mortality coverage – the net cost of pure insurance (NCPI) – are deductible by the bor-

corporation that is the beneficiary of a policy up to the amount borrowed.

Under 10/8 arrangements, the insurer credits the additional funds deposited in a policy's designated collateral account with a return that is 2 percent less than the interest rate charged on the loan. Because the policy is an "exempt policy" for the purposes of the Act, the accruing income is not taxed as a result of the operation of paragraph 12.2(1)a) and regulation 306. At each anniversary date of the loan, the full amount of the accrued

income is available to secure a further loan advance to the borrower.

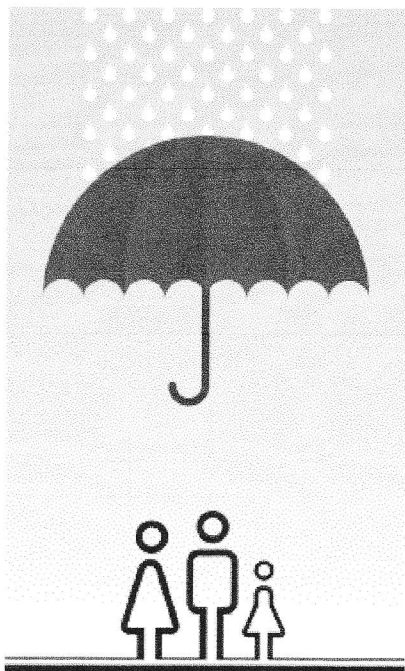
Draft Legislation

The Department of Finance has proposed that when a policy used as security for a loan meets the definition of a 10/8 policy, the following results occur:

- ✧ no loan interest deduction under paragraphs 20(1)(c) or (d) as a result of new subsection 20(2.01) (NWMM clause 11(4));
- ✧ no NCPI deduction under paragraph 20(1)(e.2) as a result of new clauses 20(1)(e.2)(ii) and (iii) (NWMM clause 11(2)); and
- ✧ reduced CDA credit for the death benefit attributable to the borrowing secured by 10/8 policies (that portion of paragraph (d) of the CDA definition in subsection 89(1) after subparagraph (i) is replaced by new subparagraphs (ii), (iii), and (iv) (NWMM clause 41(1)).

A 10/8 policy is a life insurance policy when:

- 1) an amount is or may become
 - a) payable, under the terms of a borrowing, to a person who has been assigned an interest in the policy or assigned an interest in an investment account in the policy, or
 - b) payable under a policy loan made in accordance with the terms and conditions of the policy, and
- 2) either
 - a) the return credited to the policy's investment account
 - i) is determined by reference to the rate of interest on the borrowing or the policy loan, and
 - ii) the return would not be credited to the account if the borrowing or policy loan were not in existence, or



- b) the maximum amount of a policy's investment account is determined by reference to the amount of the borrowing or the policy loan.

A policy described in (1) that meets condition (a)(i) and (ii) or condition (b) is a 10/8 policy. The NWMM makes it clear that a policy is not a 10/8 policy if the investment account under the insurance policy is available to all policyholders regardless of whether they borrow.

After March 21, 2013, if a policyholder chooses either to dispose of a policy or to withdraw the cash value from the policy investment account used for 10/8 purposes to repay a 10/8 loan, the draft legislation provides that there is no taxable income inclusion, provided that the disposition or withdrawal takes place before April 2014 under new subsection 148(5) (NWMM clause 65(5)). If the policy is a 10/8 policy and the policyholder delays the disposition or withdrawal into 2014, there will be no interest or NCPI deduction after 2013, and the CDA reduction described above will continue to apply, because the policy will continue to be

a 10/8 policy until the disposition or withdrawal.

Modifying Policies and Loans

Some life insurance companies that offer 10/8 arrangements have started to modify their existing loan and policy arrangements by revising the terms of existing collateral loan agreements, policy loan provisions, and policies that secure 10/8 loans.

The modifications to existing 10/8 policies will permit policyholders and borrowers to enter into compliant policies before 2014. Once the policies are fully compliant, the provisions in the draft legislation that deny deductions for interest and the NCPI and that reduce the CDA inclusion should not apply.

The explanatory notes offer helpful guidance concerning the application of the draft legislation when policies are no longer 10/8 policies. For example, clause 11(2) "Premiums on life insurance used as collateral" and clause 11(4) "Limitation of expression 'interest' – 10/8 Policy" make clear that the deductions are denied only when the amounts are paid or payable after March 20, 2013 "during a period after 2013 during which the policy is a 10/8 policy." As a result of this wording, 10/8 policies that have been changed to compliant policies will not be subject to the restrictions in draft legislation paragraph 20(1)(e.2) and subsection 20(2.01). In a similar vein, the Department of Finance commented in clause 41 that the CDA credit under 10/8 policies is reduced "if the policy is a 10/8 policy immediately before the relevant death." Once a policy is no longer a 10/8 policy, the CDA credit should not be reduced.

Conclusion

The draft legislation proposed by the Department of Finance provides helpful assistance to taxpayers and their advisers regarding the use of life insurance to meet business and investment needs. ■