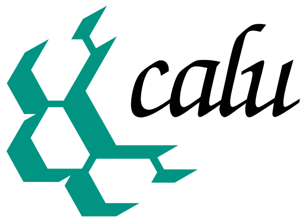

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TFSAs: Planning Opportunities & Pitfalls

By Ted Ballantyne, BBA, LLM, CMA, TEP
Director, Advanced Tax Policy, CALU

The 2008 budget proposals regarding the new Tax-Free Savings Account (TFSA) were outlined in the February 2008 *CALU Special Budget Report*. The Department of Finance released subsequent proposals in July 2008. This article reviews some of the financial planning opportunities and pitfalls that result from the implementation of this planning vehicle, which will come into effect on Jan. 1, 2009.

To summarize the main TFSA concepts:

- Canadian residents age 18 and over will start to accumulate contribution room in 2009, which may be carried forward indefinitely.
- Maximum annual contribution is $5,000, which will be indexed in increments to the nearest $500, from time to time.
- TFSA contribution room will be re-established on a dollar-for-dollar basis if funds are withdrawn from the TFSA.
- There is no maximum age requirement to commence withdrawals.
- Attribution rules are generally not applicable.
- Investments allowed are generally the same as for RRSPs/RRIFs, with the exception that life insurance policies (other than annuities, including segregated fund contracts) cannot be registered as a TFSA.
- Interest on funds borrowed for contributions is not tax deductible.
- A TFSA may be assigned as collateral for a loan.
- Transfers are allowed between former spouse's TFSAs on marriage/ relationship breakdown.
- At the death of a TFSA plan holder where there is no "successor holder," income earned in the deceased's TFSA will become taxable at the end of the year following the year of death.
- No spousal TFSAs are allowed (but each spouse may open a TFSA using funds gifted from the other spouse).
- If a Canadian resident becomes non-resident, the TFSA maintains its tax-free status for Canadian tax purposes, but further contributions are subject to a penalty tax.
- TFSAs *are not* creditor protected, with the exception of those issued by

licensed annuity issuers with appropriate beneficiary designations.

In addition, there are a number of administrative issues, which issuers and the Canada Revenue Agency are in the process of resolving. These will not be reviewed in this article.

Planning Opportunities

The introduction of TFSAs as another tax-preference investment vehicle opens a number of planning opportunities. In the 2008 budget speech the Minister of Finance gave the impression, through the examples used, that TFSAs may be used for short-term savings goals, such as a vacation or purchasing a car. While that is true, there are a number of other long-term planning opportunities, which lend themselves to this concept. These are discussed below.

Maxed out RRSP contributions

In 2009 the maximum RRSP contribution is limited to 18% of earned income or $21,000. In 2010 this increases to $22,000, and in 2011 and thereafter the maximum contribution is scheduled to be indexed. The TFSA provides a planning opportunity for those who are already contributing the maximum to an RRSP, or a combination of RRSP and RPP. At a 46% combined federal and provincial tax rate, a $5,000 after-tax contribution to a TFSA equates to about a $9,260 pre-tax contribution to an RRSP. As a result, the combination of the TFSA and maximum RRSP/RPP contributions means that tax-sheltered savings contributions are the equivalent of a gross RRSP contribution of over $30,000.

The contributions are equivalent since when a withdrawal from the RRSP is made, the amount is taxable, and assuming no change in marginal tax rate, the annuitant would have $5,000 after tax; which is the same as the $5,000 after-tax contribution to a TFSA.

While the TFSA contribution is not tax deductible, the income earned in, and withdrawals from, the plan is non-taxable; further, it is not taken into account for determining income for social benefit repayment purposes.

Income splitting

The TFSA legislation does not specifically allow spousal TFSAs, but it does not prohibit each spouse (including common-law partner) from opening their own TFSA. In other words, all Canadian residents age 18 or older start accumulating TFSA contribution room, regardless of marital status or income.

As a result, it is possible for each spouse to open a TFSA and have the higher income individual gift $5,000 to the which the spouse may use to make contributions to their spouse's TFSA, in addition to contributing to his or her own TFSA.

The only caution regarding potential attribution to the contributing spouse is if the spouse for whom the contributing spouse is making TFSA contributions starts to make systematic withdrawals from their TFSA. Consider the following example:

- In year 1, spouse A makes a $5,000 contribution to the TFSA of spouse B.
- In year 2, spouse B withdraws the $5,000. This re-established contribution room so at the end of year 2 spouse B now has $10,000 in contribution room.
- In year 3, spouse A now contributes $15,000 to spouse B's plan, ($10,000 + $5,000 for year 3).
- In year 4, spouse B withdraws the $15,000.
- The pattern continues to repeat and the amount grows over time and in effect spouse B can double up the amount invested between the TFSA and non-registered investments.

CRA may attempt to apply GAAR or the attribution rules to the interest earned in spouse B's taxable investment account to spouse A. Whether they would be successful is problematic and will not become an issue for a number of years. But, it is something advisors should be aware of.

Low-income individuals

While the author appreciates CALU members generally do not have clients at the lower end of the income spectrum, it is important to note that TFSAs provide a unique planning opportunity for lower-income individuals – say those earning less than $30,000 without the prospect of higher earnings later in their careers. According to Statistics Canada data for the 2004 tax year, over 1.6 million Canadians earning less than $30,000 made contributions to an RRSP (including the pension adjustment). The average contribution ranged between $1,313 for those with income of under $10,000 to $2,370 for those earning between $20,000 and $29,900.

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The RRSP income when received may well impact the ability of these lower-income Canadians to access government social benefits, such as the Old Age Security (OAS), or more probably, the Guaranteed Income Supplement (GIS). In fact, it is probable that a combination of CPP, OAS and GIS benefits will replace the majority of these individuals' pre-retirement income. The use of a TFSA in place of an RRSP for lower-income individuals would ensure that access to government social benefits was not impaired and would allow these individuals to enhance their retirement lifestyle, because the TFSA income is not taken into account in determining eligibility for government benefits.

The issue, of course, is where these individuals are going to obtain the requisite financial planning advice to properly maximize their post-retirement income?

Transfer of excess pension amounts

Where an individual leaves employment and is entitled to receive the commuted value from his or her defined benefit pension plan, it is likely that there will be an excess amount above what is allowed to be transferred to a locked-in RRSP or LIRA. The excess can be tax-sheltered to the extent that the person has RRSP room. If the individual has sufficient contribution room in their TFSA (or in a spouse's TFSA) the excess could be transferred into the TFSA. While the excess amount received from the pension plan is taxable to the extent it is not transferred to the RRSP, the income earned in the TFSA is tax free. Further, both the registered account and the TFSA receiving the excess transfer value could use the same investment strategy as compared to transferring the excess amount into a taxable investment account where the differing tax treatments of the various income types (dividends, capital gains/losses, interest) would need to be taken into account.

Provided sufficient notice is available and the amounts to be received from the pension are known in advance, it would be possible to withdraw funds from the TFSA in the previous year in order to re-establish contribution room for the year in which the pension funds are to be received.

While withdrawing funds from a TFSA to create contribution room means that those withdrawn funds will have to be held in a taxable account, the advantage is that the investment strategy for the excess funds received from the pension plan could be coordinated with the registered account. Whether this is of benefit in a particular situation would need to be determined on a case-by-case basis.

Post-retirement income

In undertaking post-retirement income planning, the obvious objective is maximizing family income while minimizing adverse tax consequences and the claw back of income tested government benefits, such as OAS. An important planning consideration is that income from a TFSA – whether an income stream, such as monthly withdrawals, or lump-sum withdrawals – will not be taken into consideration in determining eligibility for income-tested benefits.

In 2008, the income threshold to start repaying OAS benefits was $64,718 for an individual. This amount is indexed. Through appropriate income tax planning – such as the use of pension splitting, spousal RRSPs, and TFSAs – it would be possible for a couple to receive over $129,000 in income before being subject to the claw back of OAS benefits.

This means that post-retirement income planning needs to commence during the accumulation stage to make appropriate use of the various planning opportunities, including inter-spousal loans.

Tax planning

From a tax-planning perspective, TFSAs may be used to hold the least tax-effective investments. For example, dividends from foreign stocks do not qualify for the dividend tax credit and could be held in a TFSA, along with strip bonds, where accrual reporting is required by the investor, but there is no income reporting on the part of the issuer for the increase in value and no cash received. Similarly, interest income is less tax effective than either dividends from Canadian corporations or investments that give rise to capital gains/losses.

The appropriate mix of tax-effective investment strategies will be dependent on each client's situation, but the appropriate use of a

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TFSA to shelter the least tax-effective income from future taxation should be included in any planning discussions.

TFSA versus Principal Residence

Many individuals use their principal residence as a potential source of future retirement income, especially if they are in a large family home and intend to downsize later in life. A TFSA may offer an alternative, especially if the ownership horizon for the home is not long. This may apply, in particular, to executives whose employment requires them to move regularly, or to those who come to Canada from other countries for limited periods of time.

As neither mortgage interest payments nor TFSA contributions are tax deducible, depending on the length of time the home is intended to be owned, there is a potential tradeoff between increased home size (given the associated costs, such as real estate commissions and legal fees) and putting the amount of the mortgage payment into a TFSA.

For instance, if the cost of upsizing a home is $70,000, the incremental monthly payment, based on a 25-year amortization, would be about $427 per month, assuming a 5.5% interest rate. If that amount was instead contributed to a TFSA each year for the 25-year period, at 3% interest, a total accumulation of over $182,000 could be achieved. While this is a simplistic illustration, it indicates the type of evaluation that could be undertaken, although obviously the circumstances in each case will have to be taken into consideration.

TFSA versus HBP or LLP

The TFSA offers a viable option to the use of the Home-Buyers Plan (HBP) or Lifelong Learning Plan (LLP) options under an RRSP. While contributions to the RRSP are tax deductible, if a withdrawal is made under the HBP or LLP, the withdrawal has to be repaid over a specified time period or be taken into income over the same period. In the case of the HBP, these repayments are in addition to mortgage payments, providing an extra financial burden. (From a practical perspective, we understand that many taxpayers fail to make the appropriate repayments, and thus have an income inclusion for the required repayment that has not been made.)

Although there is no immediate tax benefit to a TFSA contribution, if it is withdrawn to be used for a home purchase or for educational reasons, TFSA contribution room is re-established and no repayments are required. In addition, if the taxpayer does not have sufficient funds in a year to make both an RRSP and TFSA contribution, it may be better for that person to make a TFSA contribution and carryforward the unused RRSP contribution room.

As a generalization, people saving for their first home are at a lower tax rate than later in life. Consequently, the tax benefit of RRSP contributions early in life is less tax advantageous than if made later in life. Thus the individual may get a greater tax benefit in accumulating RRSP contribution room and making a catch-up contribution when they are at a higher marginal tax bracket.

The TFSA can also be used when an individual is in a low tax bracket to accumulate funds. If a home is not purchased or they do not pursue additional education, the funds may be withdrawn and used as a catch up RRSP contribution, when the individual is in a higher tax bracket and will get a better tax effect on the contribution.

TFSA versus RESP

While the maximum contribution to a Registered Education Savings Plan (RESP) is now $50,000, the maximum annual Canada Educations Savings Grant (CESG) is limited to 20% of contributions up to $2,500 (total annual grant of $500). Where the RESP beneficiary does not go on to a qualified educational program, up to $50,000 may be transferred to the contributor or spouse's RRSP, but only if sufficient unused RRSP contribution room is available. Otherwise any accumulated income and grants that are withdrawn from the RESP are subject to a penalty tax of 20% federally (12% in Quebec) in addition to regular income tax payable.

The TFSA provides additional planning opportunities for parents and grandparents. While a TFSA cannot be established for a child under the age of 18, it may be more appropriate to limit contributions to the RESP to $2,500 per beneficiary, to maximize the CESG, and contribute additional funds to the contributor's TFSA with the intention these funds be used to help the child with post-secondary education. Once the child is 18 or older, the child

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starts to accumulate TFSA contribution room. The RESP holder(s) could then withdraw funds from his or her TFSA and gift these amounts to the child which the child could in turn contribute to their TFSA. These funds would then be available to supplement education costs and at the same time re-establish TFSA contribution room for the plan holder.

As the TFSA withdrawals are not taxable, this strategy would ensure that the child can maximize any tax benefits available, such as education, GST and property tax credits, if available.

Employer-sponsored TFSAs

An employer may also establish a TFSA on a group or grouped basis for employees, similar to a group RRSP. (If the employer made the contribution, the contribution would be a taxable benefit, as would employer-paid fees.) This would ensure that where employees have little RRSP contribution room another tax-effective savings vehicle is available to them. While spousal plans cannot be established under a group plan (because no spousal TFSAs are contemplated), this would allow employees to accumulate further tax-sheltered funds as opposed to taxable savings available through payroll deduction, such as Canada Savings Bonds. The investments allowed under an employer-sponsored TFSA could be the same as for the group RRSP or defined contribution RPP, thereby allowing the employee a coordinated investment strategy.

The CRA has recently confirmed that a non-employee spouse can participate in a group TFSA, however the non-employee spouse would have to make the contribution personally; the employer or employee cannot make the contribution on behalf of the non-employee spouse.

Intergenerational wealth transfer

A major advantage of the TFSA concept is that it is automatically available to all Canadian residents who are 18 years of age and older. Unused contribution room can be carried forward indefinitely. Over the next decade or so there will be a significant wealth transfer to the baby boomers from their parents. Even if TFSA contribution cannot be used today, it may be used in the future to tax shelter the income on an inheritance or a part thereof. This is a fact that should not be overlooked in financial planning with clients, especially those who may expect to receive a large inheritance.

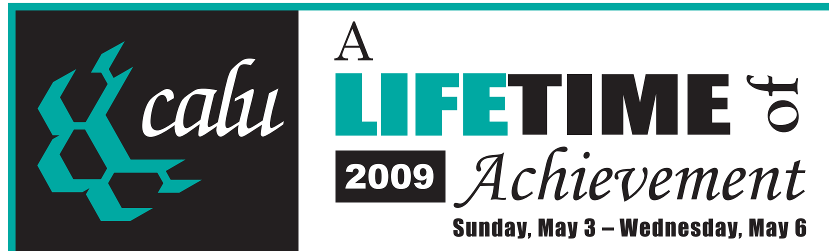
Planning Pitfalls

As with all financial products, where there are opportunities, there are also pitfalls. Two in particular come to mind.

Foreign citizens resident in Canada

A TFSA is available to all residents of Canada for Canadian tax purposes. Therefore Canadian resident foreign nationals may utilize them. However, foreign nationals may also be subject to tax in their country of citizenship (such is the case for U.S. citizens). It is therefore important for foreign nationals to determine if they may be subject to tax in another jurisdiction on income accruing in the TFSA, even though there is no tax reporting by the Canadian issuer.

It is questionable whether the TFSA is recognized or contemplated



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https://resweb.passkey.com/go/calu09

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under the various bilateral tax treaties currently in force between Canada and other countries, and thus there is the question as to the taxation of any income or withdrawals from the TFSA by the foreign nationals if they return to their home country.

This is an issue where it would be important for a foreign national to seek appropriate tax advice if he or she is considering opening a TFSA while resident in Canada.

Canadian emigrants

TFSA plan holders who depart Canada can maintain their plan and there is no tax reporting on either emigration or on surrender of the TFSA. But, similar to the issue with foreign citizens opening a TFSA while resident in Canada, there is the issue as to how the income earned in the TFSA may be taxed in the foreign jurisdiction. Again, appropriate tax advice should be sought by individuals who are giving up Canadian residency, either for employment elsewhere or, more likely, for retirement.

If contributions are made while the individual is a non-resident, they will be subject to a special tax of 1% per month on the excess contribution. This tax can be avoided if the plan holder withdraws this contribution and makes the appropriate designation.

The penalty tax provision outlined in the preceding paragraph will also apply to foreign nationals who opened a TFSA while resident in Canada, and subsequently make contributions to it after becoming a non-resident of Canada for tax purposes.

Conclusions

TFSAs will provide another product to help financial advisors meet Canadians savings and investment needs on a tax-effective basis. While such plans may be useful for short- to medium-term savings goals, the better use of these plans is for long-term investment strategies to supplement retirement income with a view to maximizing government social benefits. Given the fact that there is no arbitrary age to commence income from these plans, they can be held to provide equity growth into an individual's later years, whereas an RRSP must be annuitized by the end of the year in which the individual turns age 71. From a tax-planning perspective, TFSAs allow an individual to maximize the tax efficiency of an overall investment portfolio by holding the least tax-efficient investments in the TFSA and more tax-efficient investments in a taxable portfolio.

While it will undoubtedly take time for a market to develop it maybe worthwhile to familiarize clients or prospects with the concept and to review integrated medium- to long-term investment strategies in order to provide the most tax-effective retirement income possible.

The CRA has published detailed questions and answers regarding TFSAs for issuers. This may be found at http://www.cra-arc.gc.ca/tx/bsnss/tpcs/tfsa-celi/qstns-eng.html#partxiii for those who wish more detailed information of specific CRA positions.

CALU News

With this issue, we bid a fond farewell to Ted Ballantyne, at least in terms of his role as Editor of INFOexchange. As many of you know, Ted is in the process of a phased reduction to his involvement with CALU. As part of that process, Ted will, effective this issue, no longer be looking after this publication, but will, thankfully, continue to contribute specific articles and commentaries. That means Val Osborne and I will be working to complete this publication with interesting and informative articles, and definitely looking for your help in that department.

On that note, I am mindful of the purpose of this particular 'communication vehicle' and the rationale for its creation, all those years ago, when we were first developing CALU programming and communications. INFOexchange was created to offer an opportunity for all members to contribute articles and items of interest, in a format that did not require the technical dimension and rigour of, say, a *CALU Report*. Over the years, we have done our fair share of working with Active Members to create articles, discuss story ideas, and then help 'put pen to paper' as we used to say, turning ideas and commentaries into article form. So, if you have an idea, please feel free to share that with us. Probably best to do so through Val at membership@calu.com.

We will continue the practice of publishing four issues per year, with editorial deadlines of February 1, May 1, August 1 and November 1. We would like to have a healthy mix of taxation and legislation updates, sales ideas, product applications, public policy and political issues, as well as items related to CALU as an organization.

This is definitely an area where your help, involvement and support, will be most welcomed and appreciated.

Paul McKay, CAE

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Creditor Insurance and the Capital Dividend Account

by Florence Marino, LLB
Manulife Financial

It has long been CRA's administrative policy that a private corporation is not entitled to a credit to its capital dividend account (CDA) when debt is repaid out of proceeds from "creditor insurance." That long-standing position was successfully challenged in the case of *Canadian Movitel Inc. v. The Queen* (Docket # 2006-3071(IT)G, dated March 18, 2008. Under the terms of an unreported consent judgment, the Crown agreed that no tax should be payable by the taxpayer under Part III of the Act.

This case involved what is commonly referred to as creditor insurance. The taxpayer had a number of business loans outstanding. The shareholders of the taxpayer were insured under a group insurance policy issued by Sun Life, with Royal Bank as the plan sponsor and the beneficiary. The purpose of the insurance was business loan protection. In this case, one of the shareholders died and the insurance death benefit of nearly $440,000 repaid the taxpayer's outstanding business loans. Sun Life paid the Royal Bank directly as beneficiary under the policy.

The taxpayer added the net proceeds (i.e., insurance proceeds less premiums paid) of the life insurance death benefit to its CDA and paid the surviving shareholder a dividend of $426,000, electing this dividend to be a capital dividend. The taxpayer was reassessed for tax payable of nearly $320,000 under Part III for an excessive CDA election.

The CRA's traditional position has been that a CDA credit is available in the case of collateral insurance (where the debtor was the owner or beneficiary of the policy and the creditor was a collateral assignee). However, creditor insurance would not give rise to a credit to the CDA of the debtor corporation because the creditor, not the debtor, was the owner and beneficiary of the policy. This position is currently expressed in paragraph 6 of Interpretation Bulletin IT-430R3 "Life Insurance Proceeds Received by a Private Corporation or Partnership as a Consequence of Death" dated Jan. 7, 2003.

In this case, the taxpayer appears to have successfully argued that it was entitled to an increase in its CDA for life insurance proceeds paid directly to a creditor to repay the taxpayer's business loans under an insurance policy owned by the creditor and under which the creditor was the beneficiary. The taxpayer argued that the definition of the term "capital dividend account" does not require the debtor corporation to be a beneficiary of the policy. Rather, it argued the only requirement is that the corporation receive the proceeds and that the receipt could include constructive receipt. Since the insurance proceeds were used to extinguish a corporate debt, the taxpayer argued that the corporation had constructively received the proceeds and, therefore, should be entitled to a CDA credit.

The Crown conceded the point, allowing the appeal of the assessment of tax liability under Part III, thus permitting the CDA credit. While a consent judgment has no precedential value, it can have great practical significance particularly if taxpayers advance the same arguments in similar circumstances. It would be very hard for the CRA to take a different position in the future. But this is exactly what has happened.

At the annual conference of L'Association de planification fiscale et financiere (APFF) held on Oct. 10, 2008, the CRA was asked to comment on the impact of the *Movitel* case on its existing practice. The CRA stated that its current position remains as stated in IT-430R3. In order for a CDA credit to arise in respect of business loan insurance coverage, the debtor company must be the beneficiary or policyholder under the policy which has been collaterally assigned to the lender.

The wording of subparagraph (d)(ii) of the definition of CDA in subsection 89(1) is as follows: "all amounts each of which is the proceeds of a life insurance policy of which the corporation was not a beneficiary on or before June 28, 1982 *received by the corporation* in the period after May 23, 1985 in

consequence of the death of any person."

The CRA position is that a CDA credit is possible in respect of a life insurance policy that has been collaterally assigned to a lender under which a corporation is named as beneficiary or is the policyholder. The CRA has gone back and forth on this issue but eventually arrived at the current position in the most current version of IT-430R3 at paragraph 6 which states: "This is so because, in such cases, the proceeds of the life insurance policy would be constructively received by the debtor in its capacity as beneficiary or policy-holder, even though paid directly to the creditor in accordance with the assignment or hypothec."

The CRA's response at the APFF conference went into a lot of the detail behind the position that enables a CDA credit in respect of a life insurance policy which has been collaterally assigned or subject to a hypothec in Quebec and not in respect of creditor insurance. An unofficial translation of the CRA's analysis is as follows:

> In fact, such a situation where a life insurance policy is pledged as security by a debtor – regard-less of whether it is under a movable hypothec (Quebec) or a collateral assignment (common law provinces) – implies two distinct legal relationships: 1) a creditor/debtor relationship between the debtor/beneficiary or policyholder and the insurer; and 2) a creditor/debtor relationship between the creditor requesting the security and the debtor/ beneficiary or policyholder. In a case such as this, the insurer remains liable to the debtor/ beneficiary or policyholder with regard to its obligations under the policy. The creditor's rights with regard to the insurer are limited to receiving the policy proceeds. The creditor therefore receives the insurance policy proceeds in its capacity as the debtor's representative. In other words, in such a situation, the creditor receives the insurance policy proceeds in lieu and in place of the debtor because, under the terms of the security and the rules applicable thereto, the creditor exercises the right to collect the policy proceeds from the insurer. This exercise is carried out nonetheless under the collateral rights that the creditor holds with respect to the rights of the debtor/beneficiary or the policyholder. In situations such as these, the creditor is in fact the legal representative of the debtor, beneficiary or policyholder, for the purposes of collecting the insurance policy proceeds from the insurer.
>
> The CRA deems that, in such a situation, the life insurance policy proceeds are constructively received by the debtor in its capacity as beneficiary of policy-holder, even though the proceeds are paid directly to the creditor under the terms of the security.
>
> This reasoning does not apply in a situation where the debtor proceeds with an absolute assignment of the insurance policy, nor in cases where it is the creditor who purchases the life insurance policy, as the debtor is neither the policyholder nor the beneficiary.

As a result, the CRA is not willing to extend the argument of construc-tive receipt to creditor insurance under which the creditor is owner and beneficiary of the policy and stated that the settlement arrived at in the *Movitel* case was case specific.

In addition to the eligibility for a credit to the debtor corporation's CDA, advisors recommending collateral insurance for business loan protection as compared to creditor insurance will often cite the following benefits:

- eligibility for the collateral insurance deduction;
- the amount of individual insurance policy purchased for collateral insurance purposes would not fluctuate in relation to the loan balance, allowing for any excess insurance proceeds to be paid to the debtor corporation;
- should the debt be repaid, individual insurance would not disappear and could be used for other purposes – key person protection, business succession planning etc.;
- the individual policy can be assigned to another lending institution if the business loan is switched to a different lender.

The *Movitel* case has cast doubt on whether or not collateral insurance could be distinguished from creditor insurance in relation to the ability to generate a credit to the debtor corporation's CDA. Notwithstanding the CRA's position, taxpayers may still seek to use the arguments the taxpayer made in the *Movitel* case and perhaps get to the Tax Court to resolve the issue. However, one thing is clear – the CRA does see a distinction between collateral insurance and creditor insurance on this issue. This may be enough to tip the balance in favour of

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purchasing collateral insurance as opposed to creditor insurance in many cases.

Endnote

[1] For a full chronicle of the conflicting positions taken on this question by the CRA see the original Interpretation Bulletin, IT-430R2 dated May 18, 1991; revisions contained in IT-430R3 to replace IT-430R2 dated Feb. 10, 1997; reversal of revision for common law provinces in technical interpretation # 970718 dated April 18, 1997, and Income Tax Technical News Number 10 dated July 11, 1997; the issue respecting the Quebec Civil Code exposed in technical interpretation # 9833605F dated March 17, 1999; the Civil Code issue resolved in technical interpretation # 2002-0122944F dated July 8, 2002; ultimately clarified by the language of the current paragraph 6 of IT-430R3 released Jan. 7, 2003.

* * * * * *

About the Author

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Letter from the Minister of Finance to Financial Institutions Regarding Registered Retirement Income Funds

On Nov. 20, 2008, the Minister of Finance wrote an open letter to all financial institutions regarding the minimum withdrawal requirements from RRIFs.

The Minister's letter noted that "[Many] seniors are understandably concerned about the impact of the recent deterioration in market conditions on their financial security and I believe it is important to ensure that they do not face undue obstacles in managing their assets in these challenging times."

The letter went on to state that "[A] common misconception is that seniors must sell assets to satisfy RRIF with-drawal requirements, something many may not want to do at this time given the recent decline in value of many assets. The income tax rules permit 'in-kind' asset transfers to meet the minimum withdrawal requirements – they do not require the sale of assets."

The Minister asked all financial institutions to accommodate in-kind transfers – at no cost to clients – or offer another solution that achieves the same result. He asked that financial institutions respond to his request by Nov. 28, 2008.

This request raises a number of interesting issues for financial institutions that offer RRIF products. For instance, where a policyholder has a life insurer's segregated fund contract registered as a RRIF, the client has no claim or ownership interest in the under-lying segregated fund assets – these assets are owned by the insurer. How a transfer in kind would be facilitated is unclear. Further, how would the existing guarantees related to the registered segregated fund be handled on the transferred funds? A transfer to a non-registered segregated fund contract, "in kind" or otherwise, would usually result in an effective restart of the guarantee period, as there is a new contract.

Where a trusteed RRIF holds mutual funds, there may be an issue as to whether a transfer in kind is permitted. Typically mutual fund units or shares can be subscribed for or redeemed but not transferred to other holders, although transfers may be permitted in special circumstances. It may prove easier to redeem the mutual funds units held in the RRIF, receive cash out of the RRIF and reacquire the same units in a non-registered account or TFSA. In light of the Minister's request that "in-kind" transfers be accommodated at no cost to the client, back-end load fees may need to be waived or new units effectively grandfathered.

Finally, assuming that in-kind transfers can be accommodated, it must be remembered that the amount withdrawn is fully taxable, and therefore if tax has to be paid, the annuitant will have to look to his or her other financial resources or a partial liquidation of the transferred asset.

Ted Ballantyne, CALU, and Jillian Welch, Wilson & Partners LLB

Practice Management

(continued from back page)

provide an increase in the maximum available monthly income benefit when compared with standard employee long-term disability plans. While some GSI programs have pre-existing condition exclusions (like other group plans), this is an item that can be negotiated with the carrier. The size of the group, demographics, occupational category and industry all play a role in determining what contracts are available to an employer and at what price and under what conditions.

Inclusion of more finely tuned disability contracts in a program provides the incentive for an employee to continue their contribution to the profitability of a company while suffering from a partial or progressive disability or during a period of return to work following a disability and allows for stronger team building and continuation opportunities. This is likely to help retain key employees and to reduce the stress in employees. Definitions of disability are important. GSI contacts are individual contracts with guaranteed non-cancellable definitions, payment provisions and premiums. Unlike traditional group LTD plans, the definitions cannot be changed by the insurer. Defined partial or residual provisions help to offset the loss of income for a disabled employee and allow the employer some financial relief.

Integrated Claims

The strongest disability plans provide short-term income protection leading to a long-term insurance benefit, with close integration of the contract language between benefit plans. Programs that provide an integration of short- and long-term benefits for total or partial disability (without the requirement that the employee be totally disabled before any benefits are payable) are superior to plans that require consecutive days of total disability during the elimination period. The vast majority of claims are progressive and often intermittent in nature.

Disability plans providing partial disability benefits are more valuable to the employer, as they help to mitigate financial loss earlier. These contracts commit the insurance carrier to partial benefit payments based on the employee's loss of income due to lost time and/or inability to perform material duties. The employer continues to pay the employee partial income for part-time work and the employee has an incentive to continue contributing to the team at work. The employer does not lose the intellectual capacity contributed by the employee suffering from the partially disabling condition and the remaining healthy team members are appreciative of the employer's consideration and the employees continued efforts. Return to work following recovery is much smoother for all. Clients/customers, suppliers and various other stakeholders are encouraged to see the continuation of projects and continuity of service.

Employees need to understand how their LTD program works. Education is especially vital in implementing a program that includes any combination of a group disability contract with GSI individual policies and/or fully underwritten individual policies. Employees must understand the limitations inherent in the various contracts. The following information should be explained to the employee:

1. the definition of disability;
2. the amount of benefit they may be entitled to and the formula used to determine the benefit;
3. the definition of a pre-existing condition and how the application of this contract provision could impact a claim (only as they relate to group or possibly GSI contracts);
4. when and how to submit a claim;
5. the level of coverage available without providing medical evidence, the level of coverage available when satisfactory health evidence is provided and if increases in coverage are available at all;
6. the payment term;
7. offsets, reductions and exclusions;
8. return to work benefits;
9. an explanation of how benefits are payable for total, residual and partial disabilities;
10. whether the contract includes any cost-of-living benefit provisions;
11. access to an employee assistance program (EAP);
12. how to satisfy a benefit waiting period;
13. how the recurrence clause applies;
14. conversion options available on the individual contracts; and
15. portability of individual contracts (versus the lack of, or limited portability of, coverage in group contracts).

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The design of the group and individual plans must be coordinated to provide maximum benefits. If the individual contract provides a disability benefit payment for qualified partial disabilities (without the requirement that the employee first be totally disabled) and the group plan requires consecutive days of total disability, the claims process will be hindered by conflicting definitions. Similarly, conflicting occupational definitions can cause additional grief at claim time.

While a comprehensive integrated long-term disability program will provide income protection for a disabled employee there are other problems that require solutions.

Critical Illness

Whether or not an employee has an insured short-term disability plan, critical illness benefits can help to reduce the financial impact of a disability to the employee. The benefits can be used to provide emergency cash during the waiting period for long-term disability benefits qualification and these funds can be used in any way that the claimant wishes.

An individual's cost of living and general expenses may increase substantially during a disability and/or critical illness, yet the monthly disability benefit payable is most frequently reduced to 85% of net prior average earned income. Extra expenses often include increased travel to medical facilities and appointments, purchasing medical supplies and medications not covered under provincial or extended health care plans, increased child care expenses. There is also frequently an additional reduction in household income if a spouse takes time off work to provide care and companionship. A tax-free critical illness benefit can help fund these additional costs and may also help fund additional costs for second opinions or out-of-country care.

Individual contracts or true group critical illness plans (in which a master contract is owned by the employer with the employees considered certificate holders) are both gaining popularity and proving to be an integral part of an employer's well-designed, comprehensive living benefits plan.

Long-Term Care

As our population ages, many of our clients are concerned about whether they will have the financial resources to fund the cost of long-term care (at home or in a facility) if they require such care because of a health concern. Long-term care insurance is in its infancy in Canada. People are starting to recognize that it is an effective tool in providing and conserving financial assets later in life. Like the critical illness contracts noted earlier, long-term care insurance is currently available through "grouped" individual contracts (on a GSI basis or individually underwritten). The contracts available may not have guaranteed premiums or contractual obligations and should be examined fully.

At the time this article was written, at least one insurance company in Canada is currently offering a conversion feature that allows the contract holder to convert their individual disability coverage to a long-term care insurance contract. If an employer implemented a plan that included these types of contracts, it could prove to be an important recruitment incentive. As our demographics continue to shift, our working population ages and the lack of skilled labour increases, we expect these benefits to gain in popularity.

Effective communication and education is the key to the successful implementation and maintenance of any catastrophic living benefits program, providing a continuum of care. In our experience, once employers and employees are educated they can understand how a comprehensive living benefits program provides greater long-term financial protection for everyone.

As insurance advisors, it is vital for us to help our clients understand what kinds of catastrophic benefits are available and why providing employees or individuals with access to benefits providing a continuum of care is important. While living benefits may not be immediately appreciated, education about the costs associated with illness and disability during an individual's working years and then through their retirement illuminates the value of integrated living benefit solutions. At the very least, with education employees and employers can understand their exposures and make informed decisions to limit risk.

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Practice Management:

Continuum of Care

By Lynn Wintraub, LL.B, CFP; and Susan St. Amand, CFP, CLU, CH.F.C, TEP

Living Benefits

Trends in health care and employment are continually evolving. As our population ages, we are experiencing longer life expectancies with more individuals surviving illnesses that leave them with long-term residual health considerations. Our legislation has changed and now provides for employees working past age 65. Many employers and employees are looking for an evolution in the employer/employee benefits area. More people are concerned about the cost of health care and the availability of benefits and insurance to help defray these costs (especially as they age) and protect their long-term financial assets.

There are many reasons for an employer to provide a comprehensive benefits package to their employees. An employer may consider an employee benefits package a tool to improve employee recruitment, retention and incentive strategies. If the strategy is to attract employees you may find that an employer offers plans with an emphasis on what employees want (e.g., comparatively rich dental benefits, comprehensive access to heavily funded health care spending accounts and vision care) and not necessarily plans that are focused on long-term value.

The intent of this article is to discuss the evolution of individual living benefit solutions and their integration with employee benefit programs. Employers who are focused on providing genuine catastrophic insurance coverage tend to provide more comprehensive living benefits packages that include: short- and long-term disability, critical illness insurance, unlimited drug coverage, out-of-country medical coverage and possibly access to long-term care plans. Our comments will focus on pooled and individual living benefits.

A strong living benefits plan begins with disability insurance. Employers have a legal obligation to accommodate a disabled employee "to the point of undue hardship" as required by provincial legislation. This legal duty is an obligation whether there is an in-force comprehensive living benefits group plan or not. Designing a comprehensive, integrated plan that includes individual guaranteed contracts can help to mitigate future cost increases and can limit potential shareholder liability.

By including individual disability contracts (issued on a standard guaranteed basis or individually underwritten) as part of the group long-term disability program, both employers and employees benefit. Employers are concerned about the rising costs associated with their employee benefits program. Individual disability contracts have guaranteed contractual terms and premiums, and this provides employers with the opportunity to manage their costs more effectively. While individual contracts are initially more costly, employers do not face the concern of rising premiums with these contracts and because they are provided on a grouped basis, the insurers price them with a discount. Disability claims (on individual policies) will not impact the claims experience of the group and this will reduce the impact of traditional escalating long-term disability benefit expenses. This provides long-term premium and plan stability to the employer. As in any group program, individual contracts can be offered to employees on a class basis which enables the employer to implement them where they create most value.

When an employer has a long-term disability program that includes guaranteed standard issue (GSI) individual contracts employees who are otherwise uninsurable have access to more comprehensive coverage at preferential premium rates. Usually these programs

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