

## The Taxation of Corporately owned segregated funds

The objective of this newsletter is to provide the reader with some guidance on certain tax issues related to corporately owned segregated funds. For readers who want to learn more about the taxation for corporations on capital gains, dividends as well as other investment income or who wish to learn more about the capital dividend account, please consult our newsletters "[The Taxation of Corporately-owned Investments](#)" and "[The Capital Dividend Account](#)".

### Segregated funds

Segregated funds contracts are deferred individual variable annuity contracts for legal purposes. They consist of a specific group of investments owned by a life insurance company and held separate and apart from the insurance company's general reserves. The investments held in a segregated fund may include equities, bonds, exchange traded funds, individual securities, funds tied to trading indexes and public exchanges or any combination of these and other types of investments. Please refer to sections 450 and 451 of the Insurance Companies Act (S.C. 1991, c.47) for more information on the legal status of segregated funds.

The Income Tax Act (Canada) (ITA) deems a segregated fund to be an inter vivos trust for tax purposes and establishes the rules applicable to that trust. For instance, the ITA deems that the insurer is the trustee who has ownership or control of the related segregated fund trust property (para. 138.1(1)c) ITA). For policyholders, it is important to know that para. 138.1(1)f) ITA, establishes that a segregated fund never has any taxable income in a year because all of its income is deemed to be payable to policyholders annually. However, allocations may be more frequent. For instance, Empire Life's segregated funds allocate income and capital gains and losses monthly.

### Allocation of income

Despite having some rules around segregated funds, the Income Tax Act (Canada) does not set out rules regarding the allocation of a segregated fund's income to policyholders, only that the allocation must be reasonable. Income allocation factors for Empire Life segregated funds are not calculated on a time-weighted basis. At Empire Life, allocations of income, capital gains and losses are made to segregated funds policyholders on a monthly basis in proportion to the number of units held.



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The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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At present we use the last business day of the month as the date of record for allocations. Allocations of income and capital gains are made on a per unit basis to all policyholders who have an interest in the fund on the date of record. Therefore, a policyholder who only has premiums allocated to a particular segregated fund for five (5) days prior to the date of record and a policyholder who has been invested in the same segregated fund for the entire month will receive the same income allocations on a per unit basis.

Most of Empire Life's funds distribute capital monthly and income annually. Therefore, the capital distribution would reflect the time the policyholder held the fund. For example, if an investor purchased a fund in September, then only September, October, November and December capital distributions would be reflected on the T3 slip. However, most of our funds distribute income annually and not monthly. Therefore, the income allocation on the slip would not reflect the amount of time a policyholder held the fund throughout the year. The total units held at the end of the year by the policyholder would be multiplied by the income per unit allocation (for the year).

Since segregated funds are trusts for tax purposes, income earned in the funds will retain its nature when allocated to policyholders. Also, because of ss 138.1(3) ITA, the deemed trust is authorized to allocate capital gains as well as capital losses to policyholders. Therefore, interest, dividends and capital gains or losses realized by the segregated funds will flow through to policyholders, maintaining their nature.

All amounts allocated to the policyholders will be indicated in the T3 slip provided yearly by the insurer, making it easy for the policyholder to ensure proper tax reporting. Since income earned in segregated funds keeps its nature when allocated, these allocations will be taxable for policyholders in the same way other income of the same nature would be taxable. This is true for individual as well as for corporate policyholders. Keep in mind that the dividend gross up and tax credit mechanism only applies to individuals, not corporations.

For readers who want to learn more about the tax treatment for corporations of capital gains, dividends and investment income, please consult our newsletter "[The Taxation of Corporately-owned Investments](#)".

## Tracking the adjusted cost base (acb)

With most investments, it is not the responsibility of the financial institution or brokerage firm to report capital gains and losses for investments including mutual funds. That falls to the investor. The risk and challenge here is that ongoing transactions that impact the acb, including any increases in the acb may be missed by the investor or calculated improperly. That may result in a corporation which owns an investment, paying unnecessary additional capital gains taxes.

One advantage of a segregated fund is that the insurance company keeps track of each unit holder's acb. When units are redeemed because either the fund manager or investor makes a change in the underlying funds, the insurance company calculates any realized capital gains and losses. The insurance company then reports this on the investor's T3 slip. The advantage then is that the investor, his comptroller, or accountant doesn't have to spend time and effort tracking the ACB and worrying about whether the tracking is accurate and complete.

## Disposition of a segregated fund policy

A corporation realizes a capital gain when it sells, or is considered to have sold, a capital property for more than the total of its adjusted cost base (ACB) and the expenses incurred to sell the property. Subparagraph 39(1)(a)(iii) ITA provides that segregated fund policies are capital property unlike other life insurance policies. Therefore, gains or losses on disposition of a segregated funds policy will give rise to a capital gain or loss for its policyholder.

Situations that would result in a disposition of a segregated funds policy include a partial or total withdrawal from the policy or a switch between funds. A disposition also occurs when the annuitant under the policy dies thereby resulting in a potential tax liability for the corporate policyholder.

The calculation of the ACB of a policyholder's interest in a segregated fund policy starts by adding the total of all premiums paid. Income and capital gains allocated to the policyholder will increase the ACB of the policyholder. Acquisition fees and capital losses allocated to the policyholder will also decrease the ACB of the policyholder. It is possible that the fair market value and ACB of a policyholder's interest in a segregated fund are different since the segregated fund possibly contains assets with accrued gains or losses. These assets will not affect the ACB of the policyholder's interest until the gains or losses are realized.

As for all realized capital gains under current legislation, 50% of a capital gain realized by a corporate policyholder from the disposition of a segregated funds policy will be taxable and the other 50% will be non-taxable. The non-taxable portion of capital gains will be included in the computation of the corporation's capital dividend account balance.

### **Systematic Withdrawal Plan and Guaranteed Withdrawal Benefit**

Some policyholders may choose to establish a systematic withdrawal plan (SWP) which allows for structured, interval payouts from the segregated fund policy they own. When a segregated fund policyholder has a SWP in place, part of the segregated fund policy is sold as necessary to provide the amount that the policyholder wishes to withdraw. Therefore, the policyholder may realize a capital gain as a result of the partial disposition of his segregated fund policy. In addition to the taxable event resulting from the partial disposition of the segregated fund, the allocations from the segregated fund (interests, dividends, capital gains or losses) will be taxable for the policyholder. Capital payments, which represent deposits into the segregated fund and reinvested earnings, have already been taxed and flow to the corporate policyholder without any immediate tax consequences.

Under a guaranteed withdrawal benefit (GWB) product, the policyholder is guaranteed a certain lifetime withdrawal amount for life. As for a SWP, part of the segregated fund in which the holder of the GWB had invested is sold to provide the lifetime withdrawal amount. The holder of the GWB may realize a capital gain as a result of the partial disposition and the allocations from the segregated fund (interests, dividends, capital gains or losses) will be taxable for the policyholder.

### **Guaranteed "Top up" payments**

Empire Life's segregated funds provide contractual guarantees at maturity and death. On the maturity date, if the maturity benefit guarantee is higher than the current market value of the fund class units at the credit of the contract, Empire Life will increase the market value of the fund class units to equal the maturity benefit guarantee. The same principle applies if the death benefit guarantee is higher than the market value of the fund class units at the credit of the contract on the death of the annuitant. These increases as a result of a maturity or death benefit guarantee are commonly referred to as "top up payments".

The tax treatment of the top-up payment is not clear under current tax legislation. Empire Life's position is that maturity and death benefit guarantee top up payments are treated as capital gains. However, we will report the top up payments based on our understanding of the applicable tax legislation at the time the top up payment is payable.

In certain situations, the market value of the segregated funds policy could be lower than both the guaranteed benefit and the policyholder's ACB at maturity or at death. For instance, this could happen in situations where the annuitant under the segregated funds policy dies during a market crash. In a market crash, the market value of the segregated funds may have decreased quickly (especially with equity oriented portfolios) and the realized capital losses may not have been allocated to the policyholder before time of death. In such situations, two tax consequences may result at death of the annuitant. First, since the death of the annuitant results in a disposition of the segregated funds policy, the policyholder realizes a capital loss since the proceeds of disposition (the market value of the segregated funds at time of death) are less than the ACB of the policy. Secondly, the policyholder will realize a capital gain as a result of the top up payment paid to it as the beneficiary. The capital loss and capital gains would likely offset and the exact result (net capital gains or net capital loss) will depend on the amounts of each.

### **Capital Dividend Account (CDA)**

The capital dividend account is a notional account used to keep track of various tax-free surpluses accumulated by a private corporation that may be distributed as tax-free capital dividends to the shareholders of a corporation.

One of the components of the capital dividend account is the non-taxable portion of capital gains in excess of the non-deductible portion of capital losses. As we saw earlier, the gross capital gains or losses of a segregated fund are deemed to be allocated to the policyholder, in this case, the corporation. Therefore, the non-taxable portion of the allocated capital gains will be added to the CDA balance of a corporate policyholder while the non-deductible portion of the allocated capital losses will be reduced from the CDA balance.

Furthermore, the non-taxable portion of capital gains realized by a corporate policyholder on a disposition of a segregated fund policy will be added to the CDA balance of that corporation. In the same way, the

non-deductible portion of capital losses realized by a corporate policyholder on a disposition of a segregated funds policy will be deducted from the CDA balance of that corporation.

However, unlike for life insurance policies, the death benefits received by a corporation from a segregated fund policy will not be credited to the capital dividend account of the corporation.

Please note that the computation of the balance of the capital dividend account is very complex, and subject to many special rules. For readers who would like to know more about the capital dividend account, please consult our newsletter "[The Capital Dividend Account](#)".

## Getting money to the shareholders

Shareholders of a corporation generally receive annual income from the corporation in the form of salary, dividends or a combination of the two. These methods have different impacts for the corporation and for the shareholder.

When a corporation pays a reasonable salary to a shareholder, the salary paid is a tax deductible expense for the corporation and is taxable for the shareholder. It will lower the taxable income of the corporation and may reduce its tax liability. The salary will be taxable for the shareholder at the tax rate that applies to the shareholder's taxable income. Whether a salary is reasonable or not is a question of fact and can vary depending on factors such as the degree of involvement of the shareholder in the day-to-day operations of the business, the experience of the shareholder as well as the type of industry in which the corporation operates.

A dividend declared by the corporation is not a tax deductible expense for the corporation. However, if the corporation has a balance to its refundable dividend tax on hand (RDTOH) account and it pays a taxable dividend to its shareholder, it can claim a refund from the RDTOH account. For more information regarding the RDTOH account, please refer to the article on [\(The Taxation of Corporately-Owned Investments\)](#). An eligible or non-eligible dividend will be taxable for the receiving shareholder. A capital dividend received by a Canadian shareholder will not be taxable for that shareholder.

There are many other factors that may impact the determination of whether distributions to a shareholder should be made by means of salary or dividend. Please seek independent tax counsel to determine what method or combination of methods is most suitable for you depending on your objectives.

## Beneficiary Designation

One of the advantages of segregated fund policies is the ability to designate a beneficiary. However, when a corporation is the owner of a segregated funds policy but not the beneficiary, this may lead to unfortunate tax consequences.

If the beneficiary of the corporately owned policy is the spouse or a child of the controlling shareholder of the corporation, the receipt of the funds by either the spouse or the child would likely be considered as a shareholder benefit by virtue of subsection 15(1) ITA or as an indirect payment according to subsection 56(2) ITA. In both cases, the amount received by the spouse or the child would have to be added to the controlling shareholder's income (or to his/her estate's income). Similar tax consequences may result if a segregated fund policy is owned by an operating corporation who chooses to designate as beneficiary, either a corporate shareholder or a holding corporation owned by a child or spouse of the controlling shareholder.

Therefore, for corporately-owned segregated fund policies, the corporation should also be the beneficiary to avoid any negative tax consequences.

## Creditor protection

A corporately owned segregated funds policy, where the corporation is designated as beneficiary, does not benefit from creditor protection. If the corporation is an operating corporation, the risk that liabilities may occur is more important than for a holding corporation. Therefore, the fact that there is no creditor protection from the structure of the contract may be something to consider for the controlling shareholder.

However, if the corporation owning the segregated funds policy is a holding corporation, the fact that there is no creditor protection may not be an issue for the controlling shareholder as there may be fewer sources of significant liabilities. Indeed, the holding corporation likely has no suppliers, no employees, less risk of civil liability, etc. and consequently does not have the associated potential liabilities. Since the assets of the operating company and the assets of the holding company are independent of each other, creditors of the operating company may not have rights to the assets of the holding company. Therefore, the legal structure may provide a form of creditor protection for the corporate group except situations of fraudulent conveyance.

Considering the above, if an individual operates his business through an operating company but does not have a holding company as part of his corporate

structure, the individual could consider the following alternative. Instead of purchasing the intended segregated fund policy in the operating company, the shareholder could consider creating a new company. This newly created company would be a holding company holding the shares of the operating company. The funds that would have otherwise been used to purchase the segregated fund policy in the operating company could be transferred by means of an intercorporate dividend (which would probably not lead to a taxable event) in the holding company where these funds would then be used to buy the segregated fund policy.

As usual, before considering such alternatives, the client should seek independent, legal advice to ensure that the intended corporate structure is appropriate for the client and that the necessary steps to set up the structure are completed adequately. Setting up the new corporate structure would therefore involve some legal fees but shareholders may determine that the opportunity to reduce creditor exposure is worth the cost.

## How we can help

Our tax retirement and estate planning team can assist you and your client's other professional advisors in your tax planning involving corporately-owned segregated funds. Also, for a more complete explanation of the capital dividend account and for a deep dive on tax issues regarding corporately owned segregated funds, please consult our newsletters "[The Capital Dividend Account](#)" and the "[The Taxation of Corporately owned Investments](#)".

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