

Tax Matters

The following article will deal with the taxation of non-registered segregated funds and is based on our current interpretation of the Income Tax Act.

Structuring the Contract

A segregated fund contract has an owner and an annuitant. The owner can be the annuitant or can designate another person to be the annuitant. It is important to note that the annuitant cannot be changed after the segregated fund contract is issued. The owner can designate a beneficiary under the contract and if the designation is revocable, can change the beneficiary at any time.

Each of these three positions could be the same person or could be three separate persons. In addition a segregated fund contract could also have joint owners (with rights of survivorship or joint tenants in common), a contingent owner (subrogated owner in Quebec), a successor annuitant and a contingent beneficiary.

A client will be able to structure the ownership/annuitant/beneficiary information in order to achieve his/her longer term estate planning objectives.

Examples

- A husband may invest in a segregated fund naming himself as the owner and the annuitant. In order to ensure that these funds flow to his spouse if he were to pass away prematurely he could name his spouse as the beneficiary under the contract.
- A parent may invest in a segregated fund naming her/himself as the owner and his/her child as the annuitant. In order to ensure that the contract passes to the child upon the parent's death, the parent could name the child as the contingent owner. In this case the title of the contract would be switched automatically to the child upon the parent's passing without passing through the parent's estate.
- A married couple may invest in a segregated fund naming themselves as joint owners with rights of survivorship and themselves as annuitant and successor annuitant. Upon the first passing of one spouse the contract would continue in the surviving spouse's name. Eventually when the second spouse passes away the contract would be paid to the children as the named beneficiaries.

It is important to note that the annual tax reporting will be issued in the name of the owner.



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Corporations

A corporation could invest some of its surplus into a segregated fund contract. In this case the corporation would be the owner and would have to choose an individual to be the annuitant. The choice of who should be the annuitant would depend on whose life the maturity and death benefit guarantees would be based.

The corporation should name itself as the beneficiary under the contract, otherwise the shareholder would realize a taxable shareholder benefit on the value of the contract.

The annual T-3 slips would be issued by the segregated fund administrator to the corporation based on the calendar year (i.e. January 1st to December 31st) and this income would be reported by the corporation on its next tax return. For example a corporation with November 30, 2013 year end would report the income reported on the 2013 T-3 tax slip on its November 30, 2014 year end.

Annual Income

A segregated fund is deemed to be a trust with a December 31st year end for income tax purposes. As a trust it has the ability to flow its net income out to the unit holders with the same characteristics as the income that was received. This means that if the trust realizes interest income, dividend income, net capital gains, net capital losses, or foreign business income, the trust will then be able to allocate to each unit owner their proportionate share of each type of income. The segregated fund will report to the unit owner their share of these different types of income on a T-3 slip annually based on the calendar year.

Disposition

Upon the disposition, partial disposition or maturity of a segregated fund contract the owner may realize a capital gain if the proceeds of disposition are greater than their cost base of the segregated fund contract or a capital loss if the proceeds of disposition are less than their cost base. It should be noted that the fund administrator will report any resulting capital gain or capital loss to the owner on the annual T3 slip.

A disposition of the segregated fund contract will occur under all of the following scenarios:

- a full surrender of the contract by the owner for its market value
- a partial surrender (or withdrawal) of the contract by the owner for a portion of its market value

- the maturity of the contract for the greater of its market value and its guaranteed maturity amount
- the death of the owner if the owner is not the annuitant (if the owner is the annuitant then the contract would mature). It should be noted that the gain under this scenario can be deferred if the policy is transferred to the owner's surviving spouse.
- the death of the annuitant (or upon the death of the successor annuitant if one has been named) will trigger the maturity of the contract for the greater of its market value and its death benefit guarantee.

Any capital gain or capital loss triggered by a disposition would be reported to the segregated fund owner by the fund administrator on the annual T-3 tax slip.

The following would not be considered a disposition of the segregated fund contract:


- the death of the annuitant if a successor annuitant is named, in which case, the contract would continue until maturity or the death of the successor annuitant
- a contractual continuation of the contract upon maturity, in which case, the contract continues with a new maturity date.

It should be noted that if the owner transfers the ownership of the segregated fund contract to his/her spouse or common law partner, a tax-free rollover will occur, in which case, the receiving spouse or common law partner would take over the first spouse's tax attributes.

Adjusted Cost Base

The adjusted cost base of the owner of the segregated fund is important in determining whether the owner realizes a capital gain or a capital loss upon the disposition of the segregated fund contract. It is important to note that the fund administrator will track and calculate each unit holder's adjusted cost base of the segregated fund contract.

The most significant factors that impact the adjusted cost base are:

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Pluses	Minuses
any deposits into the contract	any capital losses allocated to the client
the sum of all amounts reported on the T-3 slip	that portion of the adjusted cost base allocated to a partial disposition

The maturity and death benefit (top up) payments at the time of maturity date or death respectively do not impact the calculation of the policy owner's adjusted cost base in the segregated fund contract. As such pursuant to our current interpretation of the Income Tax Act the payment of any maturity benefit guarantee or death benefit guarantee top up payment will be considered a capital gain and such amount will be reported on the owner's annual T-3 slip in the year of receipt.

Fund Switches

Switches between funds within the segregated fund contract can trigger a capital gain or a capital loss that will be reported to the segregated fund owner by the fund administrator. A capital gain would be realized if the market value of the fund that is being disposed is in excess of the owner's adjusted cost base of that fund. A capital loss would be realized if the market value of the fund is less than the owner's adjusted cost base of that fund.

Summary Chart – Fund Switches and Other Changes

Example	Contract Terminology (i.e. referred to as)	Potential Impact on Policy Guarantees	Taxable Disposition
Moving from fund A to fund B in same sales charge option in same contract	Switch	No	Yes (non-registered only)
Changing to a different fund class, same fund, within same sales charge option*	Reclassification of Units	No	No
Moving to same or different fund to a different sales charge option in same contract	Sell & Buy	Yes	Yes (non-registered only)
Changing from RRSP to RRIF	Change in Registration (i.e. same contract)	No	No
Moving to same fund but from non-registered to RRSP contract	Transfer	No	Yes (since tax slip will be issued for MV of fund being transferred)
Moving to same fund from one non-registered contract to another	Sell & Buy	Yes	Yes

* Changing from Class A to Prestige Class or vice-versa.

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- Automatic monthly locking-in of market gains to potentially increase the guaranteed amount you would receive at the "maturity date" or in the event of your death

- A range of fund choices available based on your personal need and designed by one of Canada's leading investment managers
- The strength and stability of BMO Financial Group, one of Canada's premiere financial institutions

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