

Docket: 2007-3803(IT)I

BETWEEN:

W. ROSS WHITE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 27, 2008, at North Bay, Ontario

By: The Honourable Justice M.A. Mogan

Appearances:

Agent for the Appellant: Gerald Potvin
Counsel for the Respondent: George Boyd Aitken

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2005 taxation year is allowed, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the amount to be included in the Appellant's income is reduced from \$24,909 to \$23,888.

Signed at Ottawa, Canada, this 24th day of July, 2008.

“M.A. Mogan”

Mogan J.

Citation: 2008 TCC 414
Date: 20080724
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BETWEEN:

W. ROSS WHITE,

Appellant,

and

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Respondent.

REASONS FOR JUDGMENT

Mogan J.

[1] The Appellant acquired a life insurance policy (term life) on September 16, 1983 when he was 48 years of age. The policy had a “return of premium” benefit for which the Appellant paid a separate premium. The policy terminated on September 16, 2005 when the Appellant was 70 years of age. Because the Appellant survived the termination of the policy, he received in 2005 a cheque from the insurer in the amount of \$24,909 representing his “return of premium” benefit.

[2] The Appellant filed his income tax return for 2005 reporting total income of approximately \$21,200 derived primarily from old age security, Canada Pension Plan, and a pension arising from employment. By Notice of Reassessment dated November 6, 2006, the Minister of National Revenue added the sum of \$24,909 to the Appellant’s reported income for 2005, in effect, taxing the Appellant’s return of premiums. The Appellant has appealed from that reassessment and elected the informal procedure. The only question before the Court is whether the amount of \$24,909 is part of the Appellant’s income for 2005.

[3] At the hearing, the Respondent produced a binder of 12 documents (12 Tabs) which was accepted by the Appellant and identified as Exhibit R-1. I will refer to some of the documents to provide additional details. Exhibit R-1, Tab 4 is the original contract of insurance (policy number 425,654) dated September 16, 1983 in which the Appellant is identified as the “Life Insured” and as the “Owner”; and Canadian General Life Insurance Company is the insurer. Tab 6 is a letter informing the Appellant that, as the result of a corporate amalgamation in July 2000, RBC Life Insurance Company had become the insurer for the Appellant’s policy number 425,654. All other terms and conditions of the policy were not changed.

[4] Tab 5 is a Policy Summary issued by RBC Life Insurance Company (“RBC Life”) to the Appellant on December 4, 2000 summarizing the basic terms of policy number 425,654. The Policy Summary contains the following statement:

Return Of Premium – This rider (ROP) provides for full refund of accumulated premiums, policy fees and premiums for the rider (without interest) upon death or Age 70.

[5] Tab 10 is a letter dated September 20, 2005 from RBC Life to the Appellant enclosing a cheque for \$24,909.20; stating that income tax may be payable; and that a T5 tax form would be mailed to him early in 2006. Tab 3 is a Canada Revenue Agency (“CRA”) form T5 issued by RBC Life to the Appellant for 2005 showing in box 13 the amount of \$24,909.20 identified as “interest from Canadian sources”. I assume that the T5 tax form was sent by RBC Life to the Appellant and to the CRA because the Notice of Reassessment dated November 6, 2006 (Tab 1) was mailed to the Appellant adding \$24,909 to his reported income for 2005.

[6] After receiving the Notice of Reassessment, the Appellant telephoned someone at RBC Life to complain about the amount of \$24,909 added to his reported income. Tab 12 is a letter dated December 13, 2006 from RBC Life to the Appellant stating in part (Note: in the passage quoted below, ROP is return of premiums, and NCPI is net cost of pure insurance):

I have verified the calculations and noted a discrepancy in your T5 issued. Namely, upon a detailed review of your policy file, it became apparent that your policy was initially issued at a smaller face value and provided for several increases in face value and premium in the very early stages of your policy. Our initial T5 did not accurately account for the lesser values and as such, our corrected calculations are stated below. As well, an amended T5 providing for a Reportable Gain on Disposition in the lesser amount of \$23,888.04 is enclosed.

The payment of the ROP is deemed to be a disposition by Canada Revenue Agency (CRA). CRA has specific guidelines on how to calculate the taxable amount. The taxable amount is referred to as a gain on disposition and is not a capital gain. Life Insurance Companies are required to report the gain on this disposition as taxable income by virtue of paragraph 58(1)(j) of the *Income Tax Act* and in accordance with CRA's rules, we must report this amount on a T5 in Box 13.

The formula to determine the amount of gain on disposition is the amount of the disposition minus the Adjusted Cost Base (ACB). CRA has specific guidelines on how to calculate the ACB. In simple terms, it is the sum of premiums paid minus the net cost of pure insurance (NCPI). However, CRA guidelines restrict us from including premiums for Double Indemnity and Waiver of Premium in the sum of premiums. The calculation of the NCPI is provided to us by CRA under Regulation 308 of the *Income Tax Act*.

The calculation of the taxable gain on disposition of your policy is as follows:

Sum of Premiums paid excluding Double Indemnity and Waiver of Premium Benefits	\$22,090.37
Total NCPI	<u>\$21,069.17</u>
Policy ACB	\$ 1,021.20
Amount of Disposition	\$24,909.20
Less Policy ACB	<u>\$ 1,021.20</u>
Reportable Gain on Disposition	\$23,888.04

We did send a copy of a policy identical to yours to CRA for an interpretation prior to issuing T5s on this benefit. CRA has indicated directly to us that the payment of the ROP is a disposition in accordance with paragraph (c) of subsection 148(9) of the *Income Tax Act*.

[7] During the hearing of this appeal, counsel for the Respondent acknowledged that the original amount (\$24,909) added to the Appellant's income for 2005 was too high. The insurer now states that the amount should have been \$23,888.

[8] The Appellant filed a Notice of Objection to the reassessment dated November 6, 2006 (Tab 1). In response to the objection, CRA sent a letter (Tab 7) to the Appellant dated April 24, 2007 stating in part:

The use of the phrase “return of premiums” causes confusion. The amount the policyholder receives is a portion of the investment (*sic*) income the insurer earned by investing the premiums. The premiums were pooled and used by the insurer to pay claims for all policies issued. Therefore, the premiums paid were used by the insurer to provide the insurance coverage, that is, to provide a service. The amount returned to the policyholder is a portion of the investment income earned on the pooled cash. The policyholder is often confused because the amount of interest they received is quantified based on the amount of premiums they have paid.

The above quoted paragraph is self-serving to the reassessment but it fails to explain why the amount \$23,888 (being almost all of the total premiums of \$24,909) should be included in his income.

[9] Tab 9 is a letter dated November 14, 2006 from RBC Life to the Appellant containing a breakdown of all the premiums paid by the Appellant under Policy No. 425,654 in the 22-year period from September 1983 to September 2005. The total of all those premiums is \$24,909.20. Tab 4 describes the four benefits provided under the original contract of insurance in September 1983:

Sum Insured (death benefit)	\$75,000
Supplementary Benefits	
- Waiver of Premium	
- Double Indemnity	
- Return of Premium	

For the first two years of the policy, the sum insured increased by 12½% each year so that, by September 1985, the sum insured (death benefit) was \$93,750. This amount is confirmed in Tab 5.

[10] The Respondent called as a witness Herbert Huck, a senior employee at RBC Life. Mr. Huck has been in the insurance industry for 24 years and is Director of Professional Advisory Services for RBC Life. He provided helpful evidence concerning how RBC Life used the premiums paid by a policy holder, and how RBC Life computed the amount which was added to the Appellant’s income for 2005 with respect to his “Return of Premium” benefit. What follows in paragraphs 11 through 15 is my attempt to summarize the most relevant parts of Mr. Huck’s evidence.

[11] When the insurer receives a premium on a life policy, there are two charges which come off the top: (i) a 2% tax to the Province of Ontario; and (ii) a commission to the agent who sold the policy. Part of the remaining premium is used to pay certain administrative costs connected with issuing and maintaining the policy: a medical examination, a doctor's certificate, mailing premium notices, collecting and applying premiums. The balance of the premium is used to provide one or more funds out of which the sum insured and supplementary benefits may be paid, and the insurer may earn a margin of profit.

[12] By the year 2000, the Appellant was paying a monthly premium of \$95.28 (see Tab 5) making a total annual premium of \$1,143.36. Within the total annual premium, the Appellant was paying \$66.00 for the ROP benefit which was payable either (i) upon death during the 22-year term of the policy; or (ii) upon the Appellant reaching age 70 at the expiry of the 22-year term. It is apparent that the value of the ROP benefit was increasing over the term of the policy as more premiums were paid, and such value reached its maximum when the Appellant attained age 70 and the term expired.

[13] Under the ROP benefit, the insurer pays to the policy holder (at the expiry of the term) or his estate (upon his death during the term) an amount equal to the total of all premiums paid under the contract to that particular time. Mr. Huck explained how the insurer financed the ROP benefit.

The return of premium benefit is basically provided by an insurance company by charging policy holders an extra premium for this amount. We invest that premium to earn some returns, but obviously the return on this premium would not be sufficient to pay the return of premium on this contract so we also rely on other policy holders who take a similar benefit, that surrender or lapse their contracts, they forfeit their right to this benefit.

So, the return of premium is partially income that we earn by investing the \$66 and partially subsidized by other policy holders in our block of business that have forfeited their right to their return of premium.

(Transcript, page 9, lines 11-25)

[14] The net cost of pure insurance (NCPI) is an amount prescribed in section 308 of the *Income Tax Regulations*. It is a mortality cost based on the 1969-75 mortality tables of the Canadian Institute of Actuaries. See Exhibit R-3. NCPI is relevant because it is an adjustment to the cost basis of a policy. Mr. Huck referred to the following computation set out in the letter at Tab 12 and quoted in paragraph 6 above:

Sum of Premiums paid excluding Double Indemnity and Waiver of Premium Benefits	\$22,090.37
Less NCPI	<u>\$21,069.17</u>
Policy ACB	<u>\$ 1,021.20</u>
Proceeds paid to Appellant	\$24,909.20
Less Policy ACB	<u>\$ 1,021.20</u>
Appellant's gain on disposition	<u>\$23,888.04</u>

[15] In the above computation, RBC Life excluded the two small amount premiums paid for double indemnity and waiver of premium benefit. The amount \$22,090.37 is the sum of total premiums paid for pure life insurance plus the ROP benefit. The greater portion of that sum was for pure life insurance. Also, the Appellant had received value (life insurance for 22 years) as consideration for the premiums paid for pure life insurance. Therefore, the NCPI could not be part of the Appellant's ACB for the ROP benefit payable upon the expiry of the term. When the NCPI is deducted from the sum of premiums (\$22,090.37), the remainder of \$1,021.20 becomes the Appellant's ACB for the proceeds he received as his ROP benefit. And when the Appellant's ACB (\$1,021.20) is deducted from the proceeds he received as his ROP benefit (\$24,909), the remainder of \$23,888 is his gain on the disposition of his interest in the policy. This ends my summary of Mr. Huck's evidence.

[16] The following provisions of the *Income Tax Act* are relevant in the determination of this appeal:

56(1) Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year,

(j) any amount required by subsection 148(1) or 148(1.1) to be included in computing the taxpayer's income for the year;

148(1) There shall be included in computing the income for a taxation year of a policyholder in respect of the disposition of an interest in a life insurance policy, other than a policy that is or is issued pursuant to

(a) ...

the amount, if any, by which the proceeds of the disposition of the policyholder's interest in the policy that the policyholder ... became entitled to receive in the year exceeds the adjusted cost basis to the policyholder of that interest immediately before the disposition.

Definitions

148(9) In this section and paragraph 56(1)(d.1) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952,

“adjusted cost basis” to a policyholder as at a particular time of the policyholder's interest in a life insurance policy means the amount determined by the formula

$$(A + B + C + D + E + F + G + G.1) - (H + I + J + K + L)$$

Where

A is the total of all amounts each of which is the cost of an interest in the policy acquired by the policyholder before that time but not including an amount referred to in the description of B or E,

B ...

L is

(a) in the case of an interest in a life insurance policy (other than an annuity contract) that was last acquired after December 1, 1982 by the policyholder, the total of all amounts each of which is the net cost of pure insurance, as defined by regulation and determined by the issuer of the policy in accordance with the regulations, in respect of the interest immediately before the end of the calendar year ending in a taxation year commencing after May 31, 1985 and before that time,

(b) ...

“disposition”, in relation to an interest in a life insurance policy, includes

(a) a surrender thereof,

(b) ...

(c) the dissolution of that interest by virtue of the maturity of the policy,

(d) ...

“proceeds of the disposition” of an interest in a life insurance policy means the amount of the proceeds that the policyholder ... is entitled to receive on a disposition of an interest in a policy ...

[17] Section 148 of the *Act* is dedicated to life insurance policies. Subsection 148(1) is concerned with the disposition of an interest in a life insurance policy; and requires an amount to be included in computing income if the proceeds of disposition of the interest exceed its adjusted cost basis. The words “proceeds of disposition” and “adjusted cost basis” are similar to the words used in the *Act* to define a capital gain. See subparagraph 40(1)(a)(i). With respect to a life insurance policy, however, any gain on the disposition of an interest therein flows directly into the policyholder’s income because of the opening words of subsection 148(1) and the specific words of paragraph 56(1)(j). It is not a capital gain.

[18] Subsection 148(9) contains important definitions. The maturity of the Appellant’s policy in September 2005 when he became 70 years of age was a “disposition” of his interest in the policy. The “proceeds of disposition” of his interest in the policy was the amount (\$24,909) which he was entitled to receive in September 2005 when the term of the policy expired and his interest therein dissolved.

[19] The definition of “adjusted cost basis” in subsection 148(9) is complicated. I am relying on the assurance of Respondent’s counsel that the only relevant parts of the formula are “A” (the positive element) and “L” (the negative element). Accordingly, for the purpose of this appeal, the Appellant’s adjusted cost basis of his interest in policy 425,654 is (on the positive side) the total of all amounts paid as premiums for pure life insurance plus all amounts paid as premiums for the return of premium benefit (“ROP”); minus (on the negative side) the net cost of pure insurance (“NCPI”) as defined by *Regulation 308* and determined by RBC Life. This leads to the following computation:

Sum of Premiums paid (pure insurance plus ROP)	\$22,090.37
Less NCPI	<u>\$21,069.17</u>
Appellant’s ACB of policy	<u>\$ 1,021.20</u>

[20] Using the relevant terms defined in subsection 148(9) and applied to the facts of this appeal in paragraphs 18 and 19 above, I return to the operative words in subsection 148(1). When the Appellant disposed of his interest in policy 425,654 in September 2005, he was required to include in computing his 2005 income the amount by which his proceeds of disposition (\$24,909) exceeded his adjusted cost basis (\$1,021.20). Therefore, the amount to be included in the Appellant's 2005 income under subsection 148(1) is \$23,888 determined as follows:

Proceeds of Dispositions	\$24,909.20
Less ACB of policy	<u>1,021.20</u>
Appellant's gain	<u>\$23,888.00</u>

[21] In substance, the Appellant must lose his appeal because he claimed that the total amount (\$24,909) which he received in September 2005 was not taxable when, under subsection 148(1), \$23,888 of that amount is taxable. Therefore, the appeal is allowed only for the purpose of reducing the amount to be included in the Appellant's 2005 income from \$24,909 to \$23,888. I have one further comment.

[22] I can understand the Appellant's frustration. Under policy 425,654 he paid total premiums of \$24,909. Those amounts were not deductible in computing his income. Those amounts were paid with after-tax dollars. In addition to his life insurance, he purchased a supplementary benefit called "return of premiums" ("ROP") for which he paid a small additional premium. Under the ROP provision, the insurer was required to pay to the Appellant at the expiry of the term an amount equal to the total of all premiums he had paid over the 22-year term.

[23] The Appellant naturally thought of the ROP benefit (\$24,909) as a return of non-taxable dollars. From his point of view, that is precisely what it was. In the view of the Canada Revenue Agency, however, the greater portion (\$23,888) of the ROP benefit was a share of the income earned by the insurer over the 22 year term. That share of income was going to be taxed in the hands of either RBC Life as insurer or the Appellant as the insured. Because he received that share, he must pay the tax.

[24] In my opinion, the phrase "return of premium" may be an accurate description of the maximum amount received by the Appellant upon the expiry of the term but it is misleading for the following reason. A very large portion of all

premiums paid by the Appellant was for life insurance. He had full value for that very large portion of premiums because his life was insured for 22 years. Therefore, it is not reasonable to think of the insurer as paying back (upon the expiry of the term) any of the premiums for which it had already provided full value. What the insurer paid as a benefit upon the expiry of the term was not, in a business sense or in an income tax sense, any part of the premiums for life insurance. It was something else. It was part of the insurer's earnings. Under subsection 148(1), it was income.

[25] According to the evidence of Mr. Huck, the provisions in section 148 of the *Act* were introduced only in 1982. Prior to that time, an ROP benefit was not taxable in the hands of the insured person. The Appellant's policy 425,654 was purchased in September 1983. It comes under the new regime. That is the Appellant's ill fortune. The appeal is allowed only for the limited relief described in paragraph 21 above.

Signed at Ottawa, Canada, this 24th day of July, 2008.

“M.A. Mogan”

Mogan J.

CITATION: 2008 TCC 414

COURT FILE NO.: 2007-3803(IT)I

STYLE OF CAUSE: W. ROSS WHITE and
HER MAJESTY THE QUEEN

PLACE OF HEARING: North Bay, Ontario

DATE OF HEARING: February 27, 2008

REASONS FOR JUDGMENT BY: The Honourable Justice M.A. Mogan

DATE OF JUDGMENT: July 24, 2008

APPEARANCES:

Agent for the Appellant:	Gerald Potvin
Counsel for the Respondent:	George Boyd Aitken

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