Docket: 2010-3217(IT)G

BETWEEN:

KARL KRATOCHWIL,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on January 13, 2012, at Toronto, Ontario.

Before: The Honourable Justice Robert J. Hogan

Appearances:

For the Appellant	The Appellant himself
Counsel for the Respondent:	Sharon Lee

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the appellant's 2007 taxation year is dismissed without costs.

Signed at Montreal, Quebec, this 7th day of February 2012.

"Robert J. Hogan"

Hogan J.

Citation: 2012 TCC 45
Date: 20120207
Docket: 2010-3217(IT)G

BETWEEN:

KARL KRATOCHWIL,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Hogan J.

[1] The appellant, Karl Kratochwil, acquired a life insurance policy (the "Policy") from The Northern Life Assurance Company of Canada ("Northern Life") on January 14, 1987. In August 1993, The Standard Life Assurance Company of Canada ("Standard Life") assumed all of the obligations under the Policy by virtue of an assignment.

[2] Under the terms of the Policy, the appellant paid a base premium of $421.75 per month or $5,061 annually for a total of $75,915 over the 15-year life of the Policy. He was also charged an additional risk premium of $262.90 per month or $3,154.80 per year for a total of $47,322 because he suffered from a heart condition, which increased his mortality risk. The premiums paid in the early years of the Policy exceeded the cost of insurance in those years, creating a capital reserve that generated investment income for the policyholder. Following the assignment of the Policy to Standard Life, the appellant was charged an additional monthly premium of $172.15 per month for a period of 24 months. The appellant paid total premiums of $127,368 over the life of the Policy.

[3] The appellant enjoyed two benefits under the Policy. First, he was insured for $300,000 over the life of the Policy. The Policy had a cash surrender value. The total premiums paid under the Policy exceeded the appellant's cost of insurance, thus allowing the establishment of a capital reserve to generate investment income.

[4] In 2007, the appellant surrendered the Policy and received the cash surrender value of $150,365.75 owed under the Policy. The appellant reported income of approximately $23,000 in connection with this transaction. He arrived at this gain by deducting his estimate of the total premiums paid under the Policy from the cash surrender value paid to him. He believed that the full amount of the premiums paid under the Policy had been refunded to him because the death benefit had not been paid out to him.

[5] As the premiums were paid with after-tax dollars, he believed that he could recover the same amount without tax. He failed to appreciate that a large part of the premiums paid under the policy was used to pay the cost of insurance, in much the same way that premiums are paid to cover the cost of insurance under a term life insurance policy.

[6] After he filed his income tax return for the 2007 taxation year, the appellant received a T5 slip from Standard Life showing that he had earned $112,094 as a result of the surrender of the Policy. The Minister of National Revenue (the "Minister") reassessed the appellant to include $89,094 in his income for the 2007 taxation year. According to the Minister, that amount represents the additional policy gain that the appellant failed to report. In determining the appellant's liability for the 2007 taxation year, the Minister made the following assumptions:

a) prior to August 2, 2007, the appellant held an interest in the Policy;

b) the Policy was issued by Standard Life on or about January 14, 1987;

c) the appellant terminated the Policy on or about August 2, 2007;

d) upon termination of the Policy, the appellant received the amount of $150,365.75, being the cash surrender value of the policy;

e) prior to the termination of the Policy, the appellant had paid total premiums in the amount of $127,368.60;

f) of the total premiums paid by the appellant, the amount of $47,322.00 was on account of supplementary premiums due to the appellant's insurance risk rating;

g) prior to the termination of the Policy, the Net Cost of Pure Insurance[1] for the Policy was $41,771.26;

h) the total adjusted cost base of the Policy was $38,275.34, calculated as follows:

total premiums paid	$127,368.60
less – supplementary premiums	$47,322.00
less – net cost of pure insurance	$41,771.26
total adjusted cost base	$38,275.34

i) the income received by the appellant upon termination of the Policy was not less than $112,090.41 (“Investment Income”) calculated as follows:

surrender value as at Aug 2/07	$150,365.75
less – total adjusted cost base	$38,275.34
Investment Income	$112,090.41

j) Standard Life reported the Investment Income on the T5 Slip and issued a copy of the T5 Slip to the appellant; and

k) in his return of income for the 2007 taxation year, the appellant failed to report the full amount of the Investment Income received from Standard Life in that year.

[7] I have reviewed the Minister’s calculations in paragraph (h) and (i) above and have determined that they are accurate.

[8] The *Income Tax Act* (the “*ITA*”) contains complex rules which allocate premiums paid under an insurance policy first to the taxpayer’s cost of insurance. The balance left over, defined as the taxpayer’s “adjusted cost base” of the policy, is used to determine the gain on the disposition of the policy. That gain is equal to the excess of the taxpayer’s proceeds of disposition over his adjusted cost base of the policy. Under those rules the appellant’s total cost of insurance is equal to $89,093. This amount is made up of the aggregate of the annual net cost of insurance and the sum of the additional risk premiums.

[9] In very general terms, the appellant is considered to have paid $89,093 over the 15-year term of the Policy in order to benefit from a $300,000 death benefit over

[1] Regulation 308 sets out the rules for calculating ‘Net Cost of Pure Insurance’. Net Cost of Pure Insurance represents the cost the policyholder has paid to be covered by insurance during the time the policyholder has held the policy and reduces the amount that is returned to the policyholder on a tax free basis when the policy is surrendered.

that period. This premium amount is insured to cover the cost of insurance in much the same way as it would have been had the appellant acquired a term life insurance policy with a $300,000 death benefit. The appellant paid total premiums of $127,368 and bore an insurance cost of $89,093. This means that only $38,275.34 in premiums was left over to be refunded to the appellant as part of the cash surrender value of the Policy. The difference between $150,365.75 and $38,275.34 is $112,090.41, which is the exact amount of the policy gain or income reported by Standard Life on the appellant's T5.

[10] For these reasons, the appellant's appeal is dismissed without costs.

Signed at Montreal, Quebec, this 7th day of February 2012.

"Robert J. Hogan"

Hogan J.

CITATION:	2012 TCC 45
COURT FILE NO.:	2010-3217(IT)G
STYLE OF CAUSE:	KARL KRATOCHWIL v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	January 13, 2012
REASONS FOR JUDGMENT BY:	The Honourable Justice Robert J. Hogan
DATE OF JUDGMENT:	February 7th, 2012

APPEARANCES:

For the appellant:	The appellant himself
Counsel for the respondent:	Sharon Lee

COUNSEL OF RECORD:

For the appellant:

Name:

Firm:

For the respondent:	Myles J. Kirvan Deputy Attorney General of Canada Ottawa, Canada