STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

Life Insurance and the Corporation

Tax implications on policy ownership changes and beneficiary structure

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Introduction

There are a variety of financial, tax and estate planning reasons for a corporation to own a life insurance policy on the life of a shareholder or key employee. Needs change and when a corporation has no further use for a life insurance policy, it may decide to transfer the interest in the policy to an insured shareholder or key employee. What happens from a tax perspective when this transfer takes place? A corporation may also fund the costs and deposit streams for life insurance policies where the shareholder or employee either owns the policy or has a personally named beneficiary for a corporate owned policy. How does the Canada Revenue Agency (CRA) view these arrangements?

Transfers and treatment

The Income Tax Act (ITA), referred to in this article simply as the Act, has a number of provisions that address various scenarios where a transfer of insurance policies involves a corporation and either a shareholder or employee. A transfer of ownership is considered a disposition for income tax purposes. Subsection 148(7) ITA will always apply when a transfer of an interest in a life insurance policy is made to either a shareholder or an employee who is deemed not to be dealing at arm's length with the corporation. The same subsection could apply when the transfer is considered to be a distribution from the corporation. The CRA considers it a question of fact whether or not a shareholder or employee is dealing with the corporation at arms length. The finding determines whether the insurance policy being transferred would be considered a distribution from the corporation. The transfer may also trigger taxable shareholder or employee benefits. When a corporation transfers an interest in an exempt life insurance policy, the income tax implication is the same as if it disposes of that interest. An exception is a collateral assignment of an interest in a life insurance policy such as in the case of securing a loan from a restricted financial institution such as a bank, trust company, credit union, life insurance company or corporation whose principal business is the lending of money to persons with whom it deals at arms length (ss. 248(1) ITA). This article will focus on absolute assignments of an interest in an exempt life insurance policy. The transfer may be a sale, gift, distribution or effected by operation of law to a non-arms length person.

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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

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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Non-arms length relationships

A person or group of related persons who controls a corporation is deemed to be dealing on a non-arms length basis with that corporation. In other words, the two parties are related. The same holds true for two corporations that are controlled by the same person or group of persons.

How is value determined?

The value of a life insurance policy is defined in ss. 148(9) of the Act and is the amount that the holder of the policy would receive if the policy were surrendered. This generally means the cash surrender value of the policy net of policy loans and unpaid premiums. The excess of the proceeds of disposition, usually the transfer price, over the adjusted cost basis of the policy is a policy gain and will be taxed to the corporation in accordance with ss. 148 (1) ITA and para. 56(1)(j) ITA as income. The full amount is included in income since life insurance is not considered capital property by virtue of the definitions found in ss. 248(1) and s. 39 ITA and the description of policy gain found in ss. 148(1) ITA. The initial, adjusted cost basis of the policy for the shareholder or employee is equal to the proceeds of disposition, usually the transfer price of the corporate owned policy (ss. 148(7) ITA).

Specific rules under ss. 148(7) ITA address the following transactions whether consideration is given/paid in the following scenarios:

i. transfer by way of gift or bequest
ii. distribution from a corporation
iii. disposition by operation of law (eg. transfer to joint tenant or joint owner)
iv. disposition to any non-arms length person except transfers to a child, spouse, common law partner or former spouse, common law partner in specific policy structures.

In any of these scenarios, the proceeds of disposition will be the greatest of:

i. the value of the interest in the policy at the time of disposition (essentially the cash surrender value)
ii. the fair market value of the consideration given, if any, for the interest in the policy and
iii. the adjusted cost basis (ACB) of the interest in the policy immediately before the disposition.

The transferor will realize a taxable policy gain to the extent that the proceeds of disposition exceed the policy's ACB.

These proceeds of disposition will also be the new adjusted cost basis of the policy for the transferee (recipient).

What happens if the fair market value of the policy is greater than its cash surrender value and no consideration is given for the interest in the policy? The policy gain will be based on the greater of the cash surrender value and the adjusted cost basis, not the fair market value. (ss. 148(7) ITA) If consideration is paid equal to the fair market value of the policy as determined using the valuation approach in Information Circular 89-3, then this higher value would be used to determine the proceeds of disposition and resultant policy gain.

The transfer triggers a potential taxable benefit to the recipient shareholder or employee. What factors are used to determine the valuation of a life insurance policy when a transfer takes place?

The valuation of a corporate-owned life insurance policy on transfer

Information Circular 89-3, entitled, "Policy Statement on Business Equity Valuations", specifies in para. 40-41 what factors would be considered in determining the value of a corporate owned life insurance policy. Also, refer to IT-416. The factors include:

1. the cash surrender value of the policy
2. the policy's loan value
3. the face amount/value
4. the state of health of the life insured and life expectancy
5. conversion privileges
6. other policy benefits including riders and double indemnity benefits
7. replacement value of the policy

If the death of the life insured shareholder or employee is "imminent", then this must also be considered, serving to drive up the fair market value past the cash surrender value and perhaps approach the estate or survivor benefit. This would be the case even if the policy did not have a cash surrender value. Other factors to consider then are:

1. the possibility that the ill life insured will recover and not die
2. the effect that the loss of a key person will have on business operations
3. whether the interest being valued represents a majority or minority of the business
4. future value of the policy, including increases in cash value and dividends

Although the valuation of a life insurance policy is not an exact science, it must meet the test of reasonableness, incorporating the known facts and reasonable, defensible assumptions for any particular situation.

Transfers and Taxable Benefits

The amount of consideration actually paid by the shareholder or employee receiving the transferred policy will impact the amount of the taxable benefit. If the transfer is made to a shareholder than ss. 15(1) ITA of the Act deems that a taxable shareholder benefit exists to the extent that the fair market value exceeds the consideration paid for the interest in the policy. When the policy is transferred to an employee, then para. 6(1)(a) of the Act states that a taxable benefit is triggered for an amount in excess of the fair market value of the policy over the consideration paid. From the corporation's perspective, the taxable benefit may be deductible in the case of a transfer to an employee and non-deductible if the transfer is made to a shareholder. Where the person receiving the policy is both a shareholder and an employee, then the transfer should be set up to provide a legitimate, employee benefit.

When a corporation pays for personally owned life insurance

Situations may arise where corporate funds are used to pay for personally owned insurance:

1. on the life of a shareholder or employee or someone related to the shareholder or employee
2. where a shareholder or employee or person related to the shareholder or employee is the beneficiary of a corporate owned policy

Here again, the funds used to pay for the life insurance policy will be considered a taxable benefit and taxed as a nondeductible expense to the shareholder under ss. 15(1) ITA or a deductible expense to an employee under para. 6(1)(a) ITA. The CRA confirmed that the benefit would be based upon the funds paid to cover the cost of the policy, not the proceeds paid under the policy.

There is a significant drawback to having a corporation pay for an insurance policy where the policy is owned by a shareholder or where the beneficiary is either the shareholder or a person related to the shareholder. Problems may also arise if the shareholder is also an employee and the taxable benefit could be treated as a shareholder rather than employee benefit. A preferred approach may be to categorize the payments as a bonus, grossed up for income tax and have the arrangement documented in an employment agreement. This may permit the total payment to be deductible to the corporation. Under this arrangement, the shareholder would own the insurance policy personally and could name anyone of his/her choosing as beneficiary(s).

When a shareholder transfers personally owned life insurance to their corporation

Periodically, we see requests for information on the transfer of a life insurance policy from an individual to a company where they hold an ownership interest. The individual need not be the life insured under the policy.

The calculation of the proceeds of disposition, potential policy gain and ACB for the recipient (corporation) are the same as mentioned earlier in this article.

Please note that the tax impact for the corporation does not depend on whether the corporation actually pays for the interest in the policy or what it pays. It makes sense then for the corporation to pay the shareholder at least the greater of the ACB of the policy or its cash surrender value. Provided that the corporation pays no more than a value equal to the deemed proceeds of disposition, the tax impact and policy gain for the transferor shareholder is the same (excess of proceeds of disposition over ACB).

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