Estate Planning in the 21st Century -
Life Insurance: Exploring the Corporate Edge - Part II*

By David Louis, Partner, and Michael Goldberg, Associate, of Minden Gross with thanks to Joel Cuperfain of Manulife Financial for his helpful comments on earlier drafts of this article

*(*This release is based on an article published in the TaxLetter, June 2004, MPL: Publishing)*

In this installment of the series, we will continue to examine the structuring of life insurance in order to arrive at an optimal estate planning structure. Three issues will be discussed: the tax consequences of transferring policies to corporations, the tax consequences of transferring policies *from* corporations, and a pitfall that can arise from the use of joint and last to die life insurance which has received very little attention.[i]

Once again the discussion will be illustrated using Harry, a fictional small business owner and his wife Bryna.[ii]

Transfers to Corporations

Given the advantages of corporate ownership, it may be worth considering transferring a personally-held policy to a corporation. As described below, the tax consequences of transfers of insurance are not intuitive and give rise to interesting planning opportunities.

One non-tax risk of transferring the policy into an operating corporation is that the policy would become subject to the claims of the corporation's creditors. However, this issue can be addressed by transferring the life insurance to a holding company instead of transferring it to the operating corporation.

For income tax purposes, the tax consequences of transferring an insurance policy are different from the tax consequences of transferring other assets. The rules pertaining to the calculation of capital gains and capital losses in section 39 do not apply to transfers of insurance policies.[iii] In addition, since a life insurance policy is not an eligible property for purposes of subsection 85(1.1)[iv] it is not possible to effect a section 85 rollover in connection with the transfer of a life insurance policy to a corporation.[v]

The tax rules in respect of the non-arm's length transfer of insurance policies are primarily contained in section 148. Subsections 148(8), (8.1) and (8.2) limit tax-deferred rollovers to certain transfers between the policyholder and his spouse and children. Therefore, it does not appear to be possible to transfer an insurance policy to a corporation on a tax deferred basis.

Subsection 148(1) provides that dispositions of insurance policies are taxable as ordinary income to the extent that the "proceeds of the disposition" in connection with the policy exceeds the "adjusted cost basis" of the policy. There does not appear to be any provision that permits a taxpayer to claim a loss on a disposition of an insurance policy.[vi]

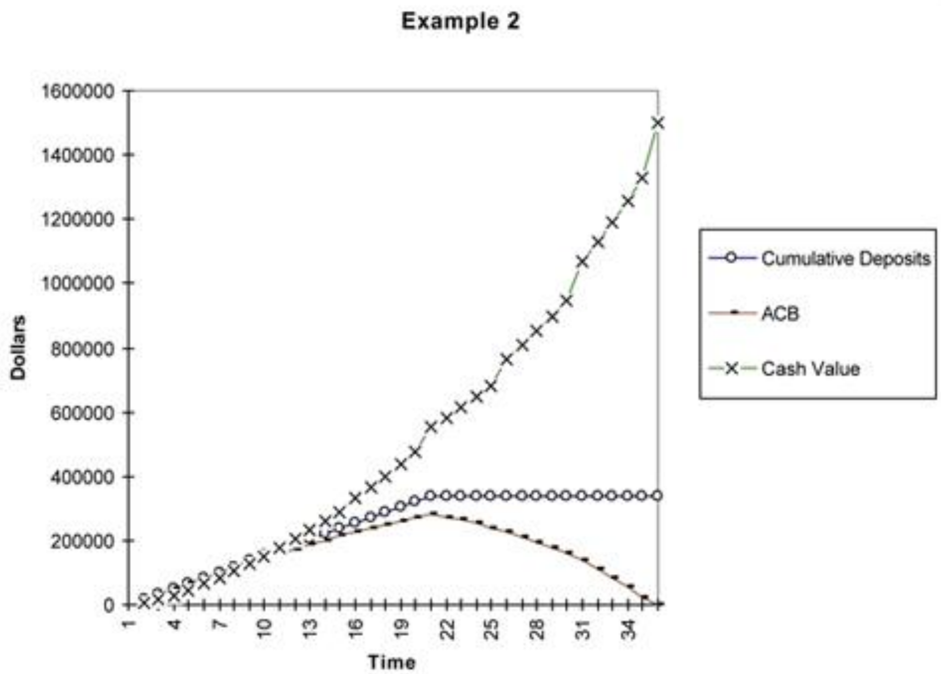
The terms proceeds of the disposition and adjusted cost basis are both specifically defined for purposes of section 148 in subsection 148(9) and will not be discussed at length. However, pursuant to subsection 148(7) the proceeds of the disposition in connection with a non-arm's length transfer of an interest in a policy is "an amount equal to the value of the interest at the time of disposition". The value of the interest is defined in subsection 148(9) and is not necessarily its fair market value. Rather, the value is either the cash surrender value (if applicable) or nil.

In many cases, insurance policies will have no cash surrender value at all. As a result, the transfer of such policies should be tax neutral to the transferor.[vii]

Where a policy has a positive cash surrender value, it will be necessary to determine the adjusted cost basis in order to calculate the tax consequences. Generally speaking, the adjusted cost basis of a policy will be equal to the aggregate premiums paid minus the cumulative net cost of pure insurance ("NCPI"). In early years, when the NCPI is relatively low and cash values may be reduced by charges to surrender the policy, the adjusted cost basis will likely exceed the cash surrender value of the policy. However, as the tax sheltered growth accumulates and the NCPI increases, at some point in time the policy's cash surrender value may well exceed the adjusted cost basis. The diagrams below illustrate policies that have these characteristics.

Fig. 1

$500,000 Universal Life policy; face plus coverage option; 6% predict rate; maximum level deposits of $17,000 paid for 20 years



Although "value" is specifically defined for purposes of subsection 148(7) as its cash surrender value or nil, an interest in an insurance policy may have a fair market value considerably in excess of its "value".[viii] As a result, a fair market value transfer of an interest in an insurance policy could involve a corporation paying a significant sum to the policy holder even though for tax purposes it appears that there will be little or no consequences. In a sense, this type of strategy would appear to provide owner-managers with the opportunity to "make up for" the previous distributions required to pay personal funding and depending on the value of the policy, possibly even more.

The results in the preceding paragraph have been confirmed by the Canada Revenue Agency ("CRA") in response to question 6 of the Round Table at the Conference for Advanced Life Underwriting on May 7, 2002.[ix] In its response, the CRA noted that so long as the shareholder merely received fair market value for his or her interest in the insurance policy, subsection 15(1) would not apply in this type of situation. The CRA also made the following comments:

The result of this transaction is that the shareholder is effectively receiving a distribution from the corporation on a tax-free basis. Notwithstanding that the corporation will have a reduced adjusted cost basis in the policy it is not clear that the above result is intended in terms of tax policy. We previously brought this situation to the attention of the Department of Finance and have been advised that it will be given consideration in the course of their review of policyholder taxation.

From a corporation's perspective, it would appear that, regardless of the fair market value and the adjusted cost basis of the policy, even where the corporation pays an amount to the transferor in excess of the policy's value (i.e., cash surrender value or nil) or where the old adjusted cost basis exceeds the policy's value, the new adjusted cost basis to the corporation will only be an amount equal to the value.[x] In a situation where the cash surrender value will always be nil, the suppression of the adjusted cost basis to the corporation will be beneficial since, when the death benefit is ultimately received by the corporation, the addition to the corporation's capital dividend account ("CDA") will be equal to the amount of the insurance proceeds less the adjusted cost basis of the policy. Otherwise, depending on whether the policy's adjusted cost basis is less than or greater than its cash surrender value, the subsection 148(7) deemed adjusted cost basis could either be suppressed, which will be beneficial from a CDA perspective but negative in the event the policy is transferred in the future, or bumped up, in which case the reverse would be true.

Turning to Harry and Bryna's situation, for the purpose of this portion of the discussion, it is assumed that 15 years have passed since we first met with the couple and that Harry (now aged 65) and Bryna (now aged 60) have come back for more advice. Since the last meeting Harry personally took out a $500,000 permanent joint and last to die life insurance policy. Unfortunately, both his and Bryna's health are failing somewhat and it is unlikely that they will be able to increase or change their current life insurance coverage.

Harry is thinking about transferring the policy to the corporation to take advantage of the planning opportunities you described the last time you met with he and Bryna. You have been advised by Harry's insurance advisor that the policy has no cash surrender value and no adjusted cost basis. You have also been advised that a professional valuator has valued the policy at $200,000.

This brings us to the fourth benefit of corporate-owned life insurance that was referred to at the beginning of Part I of this article– the ability to extract assets from the corporation.

Based on the discussion above, if the transfer of the policy is made at the policy's fair market value Harry should be able to take back corporate assets of $200,000 – tax free since pursuant to subsection 148(7) he will be deemed to have received proceeds of the disposition equal to the cash surrender value (i.e., nil) and as a result no income will be taxable to Harry under subsection 148(1) as a result of the disposition to the corporation. Even if the policy were to have any adjusted cost basis, as discussed above, it appears it is not possible for Harry to claim a loss under any provisions of the Act.

Although the corporation will acquire the policy for its fair market value, since the value is nil in accordance with subsection 148(7), the corporation will add no amount to its adjusted cost basis of the policy. Assuming the adjusted cost basis of the policy will always be nil, when the corporation ultimately receives the insurance proceeds on the death of the insured, all of the proceeds will be added to the corporation's CDA without any deduction.[xi]

Transfers from Corporations

In this portion of the article, the facts are identical to those described in the immediately preceding section, except that the $500,000 life insurance policy is assumed to have been originally acquired by the corporation and that Harry wishes to sell the corporation to an arm's length purchaser. As Harry is not insurable, he desires to remove the life insurance policy before selling the corporation.

If Harry pays fair market value ($200,000) to the corporation for the policy then from a tax perspective no tax should be payable by any party to the transaction. Pursuant to subsection 148(7) the corporation will be deemed to have received proceeds of the disposition equal to the "value," which will be nil because the policy has no cash surrender value. Since the value will be nil there should be no income to the corporation under subsection 148(1).[xii]

Although Harry will have paid fair market value for the policy, it appears that his adjusted cost basis in the policy will be nil by virtue of the application of subsection 148(7), which will deem Harry's adjusted cost basis in the policy to be equal to the policy's value.[xiii]

If Harry does not pay the corporation for the policy or pays the corporation an amount less than the fair market value of the policy, the corporate level analysis should not change. However, it appears that to the extent of the deficiency, Harry will be liable for tax under subsection 15(1) (or if the policy is received by him as an employee under subsection 6(1)(a)).[xiv]

In this scenario, the CRA has indicated that it will permit the amount of the benefit that is required to be included in the policyholder's (i.e., Harry's) income to be added to the adjusted cost basis,[xv] though it appears that there is a ceiling on the addition so that the amount added to the adjusted cost basis cannot exceed the fair market value of the policy.[xvi] Consequently, it would appear that if Harry paid nothing he should have an adjusted cost basis of $200,000 in the policy - a somewhat anomalous result when compared to the situation where Harry pays fair market value for the policy and no amount is added to the adjusted cost basis.

Joint and Last Survivor – A Hidden Trap?

Joint and last survivor life insurance is typically used for death tax planning, since the ongoing premiums would presumably be reduced due to the increased joint life expectancy. However, serious problems will arise if there has been a divorce and replacement life insurance cannot be taken out. In this case, the former spouse would continue to be covered under the joint and last survivor policy. Accordingly, the death of the surviving (former) spouse may then mean that the timing of the insurance proceeds is incorrect, e.g., if the owner-manager remarries, leaving the shares to the surviving spouse.

Suppose, for example, that Harry and Bryna get divorced and Harry marries Irene. If Harry and Irene both die suddenly, the death tax would be triggered but there would be no life insurance available to fund it. Consequently, the surviving family members could be left in a serious liquidity crunch that could result in them having to sell the corporation or other personal assets at an inopportune time.[xvii] Of course, this scenario may also arise if Harry did not remarry and passed away prior to his ex-wife.

If the possibility of marital difficulties is in any way a concern, other options to joint and last to die policies should be considered. For example, a policy could be taken out solely on the owner-manager's life or alternatively on the first to die of the owner-manager and his or her spouse. While these types of policies would normally be expected to have increased premiums, actuarially it would be expected that the timing of the receipt of the death benefit would be sooner. Furthermore, there may be significant tax benefits that can be derived from these forms of policies where an estate freeze has been previously implemented. In particular, depending on the quantum of life insurance relative to the expected death tax to be incurred, it may be possible to totally eliminate all or a portion of the death tax, without being subject to the stop-loss rules in subsection 112(3.2), where a single life policy on the owner-manager is employed and the owner-manager dies leaving a surviving spouse or where a first to die policy is employed and either spouse survives.[xviii]

---

[i] This article assumes that the reader is familiar with a number of provisions of the *Income Tax Act* (Canada) ("Act"), including matters dealt with in earlier instalments of the **Estate Planning in the 21st Century** series. Unless otherwise indicated all statutory references are to the Act.

[ii] Any references to persons living or dead are strictly coincidental.

[iii] See subparagraphs 39(1)(a)(iii) and 39(1)(b)(ii). See also CRA document no. 2000-005561B dated December 5, 2001.

[iv] Although it might be thought that a life insurance policy could, in certain circumstances, be a "capital property" and therefore an eligible property for purposes of subsection 85(1.1), capital property is specifically defined in section 54 to be a depreciable property and a property the disposition of which would give rise to a capital gain or capital loss. Since life insurance policies are not subject to capital gain or capital loss treatment they cannot be capital properties for purposes of the Act.

[v] Subject to the discussion below, it is likely that this applies to all rollovers of insurance. In CRA document no. 9211270 dated May 11, 1992, the CRA specifically indicated that it is not possible to effect a rollover of a life insurance policy under either subsection 85(1) or subsection 97(2).

[vi] In the absence of a specific provision, section 257 will deem negative amounts to be nil (i.e., a loss would be a negative amount).

[vii] As discussed in more detail below, such a disposition could result in the recipient losing its adjusted cost basis in the policy, which could be positive or negative depending on the context.

[viii] See *Information Circular* IC 89-3 for valuation factors commonly considered by the CRA. It is possible that a policy could have a relatively high fair market value in a number of circumstances, for example, if the insured is elderly, in bad health or, to be more extreme, terminally ill. See also *Mastronardi v. The Queen*, 91 DTC 341 (TCC), which has been the subject of extensive commentary.

[ix] See CRA document no. 2002-0127455 dated May 7, 2002.

[x] This result is dictated by subsection 148(7), which deems the adjusted cost basis to the recipient in a non-arm's length transfer to be the value.

[xi] Pursuant to subsection 70(5.3), the value of the policy for certain purposes, including for purposes of subsection 70(5), will be deemed to be its cash surrender value. Consequently, assuming a nominal cash surrender value, the payment made to the policyholder by the corporation could have the effect of reducing the overall value of the corporation, which, depending on the particular fact situation, could be beneficial.

If there was no existing policy in place to transfer, Harry was insurable and the corporation had excess cash reserves then another way that the overall value of the corporation could be reduced would be for the corporation to acquire a new policy designed so that the corporation is required to pay large front end loaded premiums and to have a low cash surrender value. As described above, the payment of the premiums would reduce the value of the corporation.

[xii] As described previously, there can be no loss in connection with the transfer of an insurance policy so, the adjusted cost basis of the policy would be irrelevant in this particular fact situation. In the event that the cash surrender value is not nominal, for purposes of determining the tax consequences under subsection 148(1) the gain would be reduced to the extent of the Corporation's adjusted cost basis in the policy.

[xiii So long as the cash surrender value of the policy remains nominal the suppression of value should not be problematic. However, in cases where the cash surrender value is not nominal, the suppression of the adjusted cost basis would be a disadvantage in the event of a future transfer of the policy. For reasons discussed previously, if instead of the corporation transferring the policy to Harry it was transferred to a holding corporation the suppression of the adjusted cost basis would be beneficial from a CDA perspective when the insurance proceeds are ultimately received.

[xiv] This position has been put forward by the CRA on numerous occasions (for example, see CRA document no. 2003-0004275 dated June 9, 2003). If, rather than Harry acquiring the policy, a non-shareholder such as a family member, corporate entity that he has an interest in or other person that Harry desires to confer a benefit on, were to acquire the policy from the corporation without paying for the policy or for an amount less than the policy's fair market value then other benefit provisions such as subsections 56(2) or 246(1) would likely apply to deem Harry to have income to the extent of the deficiency.

[xv] See document no. 9327305 dated January 13, 1994.

[xvi] See document no. 2003-0004275 referred to above. Although individual taxpayers will welcome the addition to their adjusted cost basis, it is not entirely clear the basis upon which the addition is made. In particular, in the more recent technical interpretation, reference is made to C of the adjusted cost basis definition. However, C only applies to increase the adjusted cost basis where there has been a disposition (as opposed to an acquisition) of an interest in the policy, such as may occur in situations involving policy loans taken in excess of a policy's adjusted cost basis.

[xvii] We understand that some insurance companies may be able to provide policies that have some flexibility to deal with this issue. However, these policies will not be able to deal with the problem in all situations and may have their own set of drawbacks associated with them.

[xviii] If as a result of death the freeze shares are transferred on a tax deferred basis pursuant to subsection 70(6) or if the holder of the freeze shares is the survivor in the first to die situation, no deemed capital gain will arise on the death of the first spouse. The CDA resulting from the receipt of insurance proceeds could then be used to redeem the freeze shares tax free, thereby ensuring that there will be no capital gain on the death of the survivor. Since there is no capital loss created, the stop-loss rules in subsection 112(3.2) will have no relevance.