TAX AND ESTATE PLANNERS' GUIDE TO CORPORATE LIFE INSURANCE

Corporate Preferred Estate Transfer® and *Corporate* Preferred Retirement Solution®

advanced insurance planning

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ABOUT EQUITABLE LIFE OF CANADA

Equitable Life® is proud to be one of Canada's largest mutual life insurance companies. We are owned by our participating policyholders, not shareholders. This allows us to focus on management strategies that foster prudent long-term growth, continuity and stability.

We are dedicated to meeting our commitments to our customers – to provide good value and meet their needs for insurance protection and wealth accumulation – now and in the future. That's why Canadians have turned to Equitable Life since 1920 to protect what matters most.

Equitable Life is a focused, stable and strong company. We have sufficient earnings and capital to meet our future growth targets, and we continue to grow steadily. Our growth in sales has been driven by our ability to implement our strategic plan, placing a priority on products, service and execution. Our financial success reflects our continued commitment to profitable growth and our ability to navigate a changing regulatory and economic environment.

Our mutual structure is a key element of our value proposition, along with our diversified product portfolio and superior service. As an organization we're progressive, competitive and firmly committed to serving the best interests of our policyholders, through longer-term strategies that foster ongoing stability, growth and profitability.

QUESTIONS

For more information, contact an Equitable Life Regional Sales Manager.

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ABOUT THIS GUIDE

This guide is a support piece for tax and estate planners who want a high level review of two unique planning opportunities using corporately-owned life insurance (COL). In addition to this guide, Equitable Life provides illustrations and marketing material for concepts that can help your clients use corporate life insurance to meet their personal estate planning and retirement needs. These concepts are:

- *Corporate* Preferred Estate Transfer®
- *Corporate* Preferred Retirement Solution®

At the time of this revision (December 2019), the information in this guide as it pertains to life insurance policies reflects changes to income tax rules which became effective January 1, 2017 (the 2017 rules) as well as changes introduced March 22, 2016. In addition, the document continues to reflect the pre-2017 income tax rules where they differ from the current rules. The 2017 rules apply to policies issued after December 31, 2016 and policies that have lost their pre-2017 tax designation. Additional changes to legislation after February 2017 may impact the information in this guide.

Tax and estate planning is complex and situational. Please ensure that competent tax and estate professionals have independently verified the law and the provisions of the Income Tax Act as they apply to the facts of a particular situation prior to implementation.

TAX AND ESTATE PLANNING POINTS - EXECUTIVE SUMMARY

Corporate life insurance policies should be considered part of the basic toolkit of every tax and estate planner dealing with private corporation shares. The planning points are:

- a corporation may purchase life insurance policies using retained earnings or by using leverage.
- corporate life insurance creates liquidity to pay taxes and debt on death.
- in family business succession planning non-active children can be treated fairly through the payment of death benefit proceeds.
- corporate life insurance may supplement other post-mortem tax plans.
- taxable investments may be re-allocated as deposits to the policy.
- investments in an exempt policy grow tax free as they are excluded from accrual taxation under subsection 12.2(1).
- the death benefit proceeds of the policy – the total money paid on death - above the adjusted cost basis (ACB), may be credited to the capital dividend account (CDA).
- dividends paid from the capital dividend account may be excluded from the income of the shareholder under paragraph 83(2)(b).
- a policy can accumulate significant cash surrender value (CSV).
- CSV may be assigned as collateral for a loan.
- a life insurance policy may be used as collateral for a loan.
- where a corporately-owned life insurance policy is used as collateral for a loan taken by the shareholder, the potential for taxable shareholder benefits must be considered. The value of shareholder benefits may be impacted by any arrangements between the shareholder and the corporation as well as the value of any guarantee fees paid by shareholder to the corporation.
- provided the collateral loan is within the lending limit of the lender additional collateral may not be required.
- depending on the lender and terms of the loan, interest on a collateral loan may be capitalized. If a policy loan is obtained, interest may be capitalized if there is room within the lending limits of the policy loan.
- a policy loan does not have to be re-paid while alive. With a collateral loan, depending on the terms of the loan agreement, it may be possible to structure the loan so that it does not have to be repaid until death. If the shareholder is the borrower, arrangements may have to be made with the lender to allow for the loan to be repaid indirectly from the death benefit proceeds of the policy.
- if the corporation is the borrower, the loan proceeds can be paid out as dividends to reduce the value of the corporation and shares in the estate, as part of a wasting freeze or otherwise.
- interest paid on corporate loans to pay dividends may be deductible if used for an income earning purpose and there is sufficient income in the corporation to use the deduction.
- if interest is deductible, the lesser of the policy premiums paid or payable, and the net cost of pure insurance (NCPI) of an assigned policy may be deductible under paragraph 20(1)(e.2) if other conditions are met.
- GST/HST does not apply because life insurance is a financial instrument; and, the provision of services related to, including the payment of death benefit proceeds of life insurance, are exempt financial services. The provinces and territories impose a premium tax of 2% to 4% which is paid by the insurance company.
- individual life insurance premiums are generally not subject to provincial sales tax (PST).

In order to plan effectively with corporate life insurance it is necessary to understand its legal properties, tax attributes and accounting treatment.

THE LAW OF LIFE INSURANCE

Life insurance is a distinct body of law in the same sense that the laws of tort, trusts, and contract are distinct bodies of law.

Much of the law on life insurance is codified in the insurance acts of each province and territory. The taxation of life insurance is codified in s.148 of the Income Tax Act ("Act") along with numerous regulations.

Life insurance is the solution society has designed to meet the financial needs that arise on death. To meet those financial needs, life insurance offers purpose-built tax and estate planning opportunities that do not exist elsewhere.

LIFE INSURANCE AS PROPERTY

In property law terms, a life insurance policy is a legal right that is enforceable through the courts. The legally enforceable rights granted by a policy are defined in the insurance contract issued by the insurance company.

A policy is initially purchased from an insurance company. Only life insurance agents licensed by the provincial/territorial regulator may sell life insurance policies on behalf of insurance companies.

PURCHASING A CORPORATE LIFE INSURANCE POLICY

A life insurance company (insurer) initially issues a policy. There must be a policyholder, a life insured, an insurable interest, and a beneficiary.

a. *Policyholder* - The "policyholder" is the owner of the policy. The owner of the policy has the right to make all of the decisions that are permitted in the contract including assigning the policy as collateral and changing the beneficiary. Where the policy is assigned or an irrevocable beneficiary is named, the owner's right to make decisions regarding the policy is restricted.

b. *Life Insured* - The term "life insured" refers to the person whose life is "measured" based on health, insurability and life expectancy through a medical underwriting process to determine the cost and terms of the policy. The death benefit proceeds of the policy are paid on the death of the life insured. Only a living person may be a life insured; therefore, before an insurer can issue a policy to a corporation (or anyone else) a life insured must be identified. In addition, there is financial underwriting to match the terms of the policy to the financial needs of the policyholder in order to prevent speculation.

c. *Insurable Interest* - Anytime that the policyholder is not the life insured the policyholder must establish an "insurable interest". In general terms, a corporation has an insurable interest in its shareholders, directors, employees, key persons and persons who consent in writing to be the insured. In addition, an insurable interest may be based on a "pecuniary interest": an example is where a bank requires life insurance to be issued on a borrower to protect its pecuniary interest in a mortgage. In addition, there is financial underwriting to match the terms of the policy to the financial needs of the policyholder in order to prevent speculation.

d. *Beneficiary* - The term "beneficiary" refers to the person/entity entitled to the death benefit proceeds at death. A life insurance policy is like all common-law property, drawing a distinction between legal title and beneficial interest. The policyholder holds the legal title. The policyholder retains the beneficial interest in being able to make all decisions regarding the policy and fully benefit from the CSV while alive. The beneficiary of a policy only has the right to receive the death benefit proceeds of the policy – if there are any left over after the CSV loans are paid.

   Choosing the beneficiary - The corporation/policyholder has the right to choose any beneficiary, be it a living person, or legal entity including a trust or partnership. The beneficiary is initially chosen through a "designation" in the policy application filed with the insurer. After the policy is issued the corporation has the right to change the beneficiary by written "declaration" if the beneficiary is not irrevocable.

   The insurer should be immediately advised of a change in beneficiary. A beneficiary declaration by a corporation may be evidenced by director's resolution or other authorized corporate record.

   In order to change an irrevocable beneficiary written consent is required from that beneficiary.

Shareholder benefit - Generally a corporation names itself as the beneficiary of a policy. The assessing position of the Canada Revenue Agency (CRA) is that where corporate assets fund a policy, the death benefit proceeds ought to be paid to the corporation. If a corporation names a shareholder as a beneficiary, the CRA will assess a shareholder benefit in the amount of premiums paid.

Subsidiary or a parent corporation as beneficiary - A corporation could name either a subsidiary or a parent corporation as a beneficiary or irrevocable beneficiary. This may be done for creditor protection reasons. This is addressed in the CREDITOR PROTECTION OF A POLICY section of this guide.

CRA is generally not concerned where the money flows downward from parent to subsidiary except where there is an attempt to confer a benefit in order to reduce taxable income. CRA states that a parent corporation may lend to, or fund, the activities of a subsidiary including providing insurance. The overall "economic value of the unit" has not changed, the parent is simply moving value into the investment it has in the subsidiary.

Going the other way where money flows upward from subsidiary to parent corporation CRA has concerns. Two situations have been considered:

- a subsidiary names a parent corporation as beneficiary; and
- a subsidiary beneficiary pays the premiums on a policy owned by the parent

When money flows upward, CRA says that the subsidiary is benefiting the parent corporation. The logic is that the subsidiary's economic value is reduced (the subsidiary is being "impoverished") and moved up to the parent corporation (the parent corporation is being "enriched"). CRA insists that:

- where the subsidiary names the parent corporation as beneficiary the parent has to pay tax on a shareholder benefit in the amount of the premiums; and
- where the subsidiary beneficiary pays premiums on a policy owned by the parent, the parent corporation should declare the amount paid by the subsidiary as income

Although neither of these assessing positions have been tested in the courts, from a tax perspective there is typically no need to risk an adverse assessment such that the same corporation should usually own the policy, pay the premiums and be named as the beneficiary.

CREDITOR PROTECTION OF A POLICY

Creditors of the corporation can seize the CSV during the life of the insured, or the death benefit proceeds of a policy on the death of the insured. Protection from creditors during the life of the policy and at death is a function of the type of beneficiary (revocable versus irrevocable) and, in the case of a revocable beneficiary, the relationship between specified family members of the life insured or of the policyholder (for Quebec) may be a factor. In most circumstances, a creditor cannot seize the CSV of the policy where a family member or irrevocable beneficiary is designated.

The provincial/territorial Insurance Acts extend creditor protection to two types of beneficiaries: family member beneficiaries, and irrevocable beneficiaries. The legislative policy is that the needs arising prior to and upon death outweigh the needs of creditors. A policyholder however, cannot designate itself as an irrevocable beneficiary and receive creditor protection.

Irrevocable beneficiary - Corporations do not have family members therefore the only option for creditor protection of the policy is to name someone, or some other legal entity, as the irrevocable beneficiary. The effect of an irrevocable declaration is that the corporation can no longer make decisions, assignment or change of beneficiary. Irrevocable means the consent of the irrevocable beneficiary is required to make any changes to the policy including changing the beneficiary. Although the effect is uncertain, a corporation can obtain a "consent to change of beneficiary" signed by the irrevocable beneficiary, to be held in escrow and released in the event of insolvency.

From a practical perspective, the normal methods of creditor protection for corporations through the use of holding companies and trusts still apply.

POLICY VALUATION

There are two approaches to policy valuation. One is fair market value (FMV) and the other is cash surrender value (CSV).

CSV is a term used in this guide to refer to the term "value" as defined in s.148(9) of the Act. Value is defined in s.148(9) as the CSV of a policy. CSV, not fair market value, is used as the value of a policy for a number of purposes in the Act, including: calculating the gain realized by the transferor of a policy to a non-arm's length person or by a corporation to a shareholder; value of a corporation when calculating the value of shares owned by a shareholder when the policy insures that shareholder or a related person; and, asset value tests for the small business deduction and the capital gains exemption.

The CSV may be substantially different from the FMV of the policy. Policies are issued based on medical underwriting. Over time, after the policy is issued, the insured may become rated or uninsurable. In this worsened state of health, an insurance policy would become prohibitively expensive or unobtainable. A policy already in existence with rates established while the insured was healthy can become quite valuable.

The FMV of the policy, not the CSV of the policy, is used to calculate the benefit received by a shareholder when a corporation transfers a policy to a shareholder or related person. CRA has stated that FMV policy valuations are to take into account all factors that affect the payout of the policy; health, riders, conversion privileges etc. CRA acknowledges that in certain situations the FMV may approach the value of the death benefit proceeds of the policy. FMV policy appraisals are routinely performed by a number of actuarial firms.

Prior to March 22, 2016 the CRA permitted transactions where a non-arm's length shareholder sold a policy to a corporation for FMV. This non-arm's length transaction was deemed to occur at CSV under subsection s.148(7) and (9) with no other tax consequences to the shareholder. Where FMV significantly exceeded CSV, the shareholder received a tax-free payment equal to the FMV from the corporation. The corporation's ACB after a purchase of a policy from a non-arm's length shareholder was deemed to be the amount of the CSV, not the FMV. This meant a higher amount may be credited to the CDA on death than if the ACB was set at the FMV value.

This planning opportunity was eliminated for transactions occurring after March 21, 2016. Under the current rules, for sales of the policy by a shareholder to their corporation for FMV, the deemed proceeds of disposition is the greatest of the CSV, the policy ACB and the actual FMV of the consideration paid by the corporation to the shareholder. If the FMV received by the shareholder was greater than the policy's ACB, the shareholder would be taxed on a gain equal to the FMV less the policy's ACB. The corporation is deemed to acquire the policy at that same amount. If the FMV was paid, the ACB of the policy for the corporation would be equal to the FMV (if it was greater than the policy's ACB.). This means that it is no longer possible to remove excess value from the corporation through the sale of a life insurance policy by a shareholder.

In addition, retroactive changes will impact the CDA benefit on death for non-arm's length transactions after 1999 and before March 21, 2016.

ATTRIBUTES AND ACCOUNTING FOR A CORPORATE LIFE INSURANCE POLICY

To qualify for tax-free investment growth and crediting to the CDA, the policy must be an "exempt policy". An exempt policy is defined based on actuarial calculations set out in the tax regulations. The exempt policy calculation allows for a limit to be imposed on the cash value build up in the policy. It is the responsibility of the insurance company to test a policy to determine its status as exempt or non-exempt. If the cash value in a policy, as defined by the Income Tax Act, exceeds the amount allowed in an exempt policy, the policyholder has 60 days from the end of the policy anniversary date to remove the excess and potentially restore the exempt status.

The maximum amount permitted is subject to differing calculations with policies issued or resulting from conversion after 2016 subject to newer rules based on a more standardized definition applicable across product types. It is generally expected that the available tax-free accumulation room will be lower than previously existed for policies issued or last acquired before 2017.

The CSV of a life insurance policy is a controllable asset to be accounted on the corporate balance sheet. As a passive asset, CSV is included in the asset testing for the small business deduction and the capital gains exemption. The death benefit proceeds are an uncontrolled contingent amount not recorded on the balance sheet. The premium paid that exceeds the CSV growth is recorded as an expense when meeting certain requirements. Where the increase in CSV exceeds the premium paid in a year, it is recorded as other (non-taxable) income. The death benefit proceeds eliminate the CSV on the balance sheet and the excess is recorded as other (non-taxable) income.

The attributes of a policy relevant to taxation are premiums, NCPI, ACB, CSV, and CDA. Each of these attributes can be found, year by year, in columns in the illustration when the policy is issued. This illustration demonstrates how the policy might work. The actual values will be different as they change from time to time. Current information can be obtained from the client's online Equitable Client Access account or by contacting their agent of record or Equitable Life's customer service area.

a. *Premiums* - Premiums/deposits in excess of cost of insurance (COI) determined by the insurer contribute to the policy's fund value. Each premium amount will be shown in the illustration. Where the policy has a positive fund, it may build up a sufficient level so that the income generated in the policy each year is sufficient to pay the annual cost of insurance. Once a policy becomes self-funded it becomes tax efficient because you no longer require retained earnings to pay the premiums, you are now using tax-free dollars to pay the COI.

   The date that external premiums are no longer required is called the offset date. Initially the offset date is based on assumptions shown in the illustration. Provided the policy performs in accordance with these assumptions, premiums will no longer be necessary after the offset date. It may be desirable to continue depositing funds into the policy in order to make use of any tax-exempt room available. The withdrawal of funds from the exempt portion of the policy will be subject to tax rules and may have reportable taxable income. This may also adversely affect the offset and payment of premiums may need to be restarted.

b. *Net cost of pure insurance* (NCPI) - The legislated cost of insurance as defined in the regulations to the Act. It is different than the COI used by the insurer. The annual cumulative NCPI can be found in the illustration of the policy.

   The annual NCPI reduces the ACB of the policy each year. This is because the annual coverage is considered a benefit. Over time, the cumulative NCPI may completely eliminate the ACB. The deduction for the NCPI is theoretically intended to have the ACB of the policy reflect just that portion of the premiums supporting the investment element of the policy.

   Where a policy is assigned to a lender such as a bank, credit union or insurance corporation, the assignment is required by the lender as a condition of the loan, and where the loan is used to generate income from property or business, a deduction may be available. The deduction is generally limited to the lesser of the premiums paid or payable and NCPI for the year. This amount is prorated on a proportional basis between the amount of the loan and the amount of the policy assigned. Therefore, if the average loan for the year is $1 million, and the death benefit on the policy is $2 million, only 50% of the lesser of the premiums paid or payable and NCPI is deductible.

c. *Adjusted cost basis* (ACB) - The ACB of a policy is basically the premiums minus the NCPI; however, there are other adjustments. These adjustments are found in subsection 148(9) and include:

   - a dollar for dollar reduction for policy loans
   - partial pro-rated reduction for partial surrenders
   - a dollar for dollar increase for policy loan repayments up to the amount by which the ACB was reduced by the loan

   The ACB is the amount that the corporation can get back from the policy prior to death on a tax-free basis through a policy loan or on surrender of the policy. The ACB can be restored tax free because premiums are paid from after-tax dollars. On death, the ACB amount is paid as part of the tax free death benefit proceeds to the corporation but the ACB amount cannot be credited to the CDA.

   The insurance company is responsible for calculating and tracking the ACB of a policy.

d. *Cash surrender value* (CSV) - The total amount of money that the policyholder can obtain by surrender, partial surrender, or policy loan. Surrender means termination of the policy and loss of the death benefit, and partial surrender means partial cancellation and partial loss of the death benefit. The insurance company computes CSV daily. Some policies have surrender charges in the early years that are deducted from the fund value when calculating the CSV.

   The definition of CSV in s.148(9) simply provides that CSV shall be computed without regard to policy loans, policy dividends* (other than paid-up additions), or, any interest payable on those dividends. This means that the CSV of the policy is not reduced by any outstanding policy loans. When a policy is terminated the funds received by the policyholder will be net of any outstanding policy loans.

* Dividends are not guaranteed and are paid at the sole discretion of the Board of Directors. Dividends may be subject to taxation. Dividends will vary based on the actual investment returns in the participating account as well as mortality, expenses, lapse, claims experience, taxes and other experience of the participating block of policies.

e. *Capital dividend account* (CDA) - The notional tracking account defined in s. 89 of the Act for non-taxable amounts that can be paid as tax-free capital dividends. Death benefit proceeds in excess of the policy's ACB increase the CDA.

The death benefit proceeds that are assigned to the bank and used to pay a collateral loan are constructively received by the corporation when the bank applies the death benefit proceeds to reduce the corporation's indebtedness.

The mechanics and maintenance of the CDA in the corporate financial statements are the responsibility of the accountant. A capital dividend must be declared by way of a director's resolution but it should never be declared without confirmation from a tax professional that the CDA balance is sufficient to allow for the dividend. It is a good practice to track the annual balance of the CDA in a note to the financial statements. Generally, amounts which would be received tax-free if received directly by an individual may be included in the CDA of a corporation in order to preserve the tax-free nature of such amounts upon distribution to shareholders of the corporation. Where the CDA has a positive balance a capital dividend may be paid.

The most common of amounts to be included in the corporation's CDA are:

- the tax-free portion of capital gains realized by the corporation to the extent they exceed the non-deductible portion of the corporation's capital losses;
- capital dividends from another corporation; and
- death benefit proceeds from the life insurance policy less the policy's ACB.

POLICY GAIN VERSUS A CAPITAL GAIN

A life insurance policy is not "capital property" since the Act specifically excludes life insurance policies from assets that give rise to a capital gain or loss at s. 39(1)(a)(iii).

Section 148(1) provides that on a disposition of an interest in a policy the amount, if any, by which the proceeds of disposition exceed the ACB, shall be included in income. The insurance industry calls the reportable amount to be included in income a "policy gain" even though that term is not used in the Act. As a policy gain constitutes income from property that is not a capital gain, the entire gain is included in income.

Both a capital gain and a policy gain are measured as the amount by which the proceeds of disposition exceed the ACB although separate calculations apply to capital property versus life insurance policies. For capital property ACB refers to the "adjusted cost base" of the property whereas for life insurance policies ACB refers to the "adjusted cost basis" of the policy. The term "proceeds of disposition" is also defined differently for capital property and life insurance policies.

The term "interest" in a policy is not specifically defined under tax law. It generally refers to a right or ownership in one or more elements of a life insurance policy. The term "if any" in the determination of the income inclusion on the disposition of an interest in a life insurance policy is added to ensure that losses (to investments in the policy) cannot be deducted. The comparative income inclusion rates are as follows:

- Capital gain - 50% of the gain is included in income for: lifetime dispositions, and, deemed dispositions on death
- Policy gain - 100% of the gain is included in income for lifetime dispositions. Since the definition of disposition excludes a payment of life insurance proceeds on the death of the life insured, proceeds of an exempt policy are received tax free.

PROCEEDS OF DISPOSITION OF A POLICY

We have seen that s. 148(1) defines the amount to be included in income as - the amount, if any, by which the proceeds of disposition exceeds the ACB.

From that starting point, the Act identifies certain transfers where there is a concern that the proceeds of disposition will be less than FMV:

- a gift (during life or by will)
- distribution from a corporation
- by operation of law, or
- to any non-arm's length person

These transfers are listed in s.148(7). The proceeds of disposition are deemed to be equal to the "value" of the policy for these listed dispositions occurring before March 22, 2016. This value of the policy is defined in s.149(9) as CSV. The person who acquires the policy by virtue of this disposition is deemed to acquire it at a cost equal to the "value" (ACB = CSV) at the time of the transfer. For these dispositions occurring after March 21, 2016 the proceeds of disposition and the ACB to the person who acquires the policy are defined as the greatest of the "value", ACB and actual consideration paid.

The definition of disposition is expanded by s.148(9) to include, among other things:

a. *a surrender*, which includes a partial surrender - the ACB is pro-rated in a partial surrender resulting in reportable income if any.

b. *a policy loan* - the proceeds of disposition are tax free until the ACB is reduced to zero. The amount of the policy loan in excess of ACB is taxable. Where a policy loan is repaid, the previously taxed amount is deductible from income and the untaxed amount is added to the ACB.

Where a policy is transferred from a corporation to its shareholder, for no consideration, the corporation is deemed to sell the policy for its CSV. CRA has taken the position that s.15(1) applies a shareholder benefit equal to the FMV of the policy on the basis that this provision is more specific in this situation. Presumably, the CRA position will be unchanged despite the amendments made to subsection 148(7). Even if the policy has been distributed to a shareholder as a dividend in kind, the shareholder is required to report a taxable dividend received equal to the policy's FMV.

ESTATE TRANSFERS - POST-MORTEM PLANNING

Post-mortem tax planning has been developed to deal with the potential double tax liability that exists when a shareholder dies owning shares of a private corporation.

First Tax - When the owner of a corporation dies, there is a deemed disposition of their shares for tax purposes immediately before death. The resulting capital gain (or loss) is computed as the excess (or deficit) difference between the FMV of the shares and the ACB of the shares immediately prior to death. The FMV of the shares is based on the FMV of the assets and liabilities inside the corporation. Generally, any gain on the deemed disposition increases the ACB of the shares transferred to the estate while any loss decreases the ACB. We will refer to this adjusted ACB of the shares the estate receives as FMV ACB. If the estate can sell the shares to an arm's length party, then the FMV ACB amount will be received tax free by the estate and the estate no longer has to concern itself with the corporation as it has been sold.

Second Tax - If the estate cannot sell the shares to an arm's length party then the FMV ACB may be stranded; and, the estate will have to continue to deal with the corporation and consider the taxes that will be paid when the corporation disposes of its assets (capital gains taxes and recapture) and distributes the assets or the sale proceeds to the shareholders of the corporation as dividends.

Combining the tax at death and the taxes paid by the corporation and the shareholder on disposition and distribution of assets, in a worst-case scenario greater than 50% of the FMV of the corporation may be required to pay tax. As a result, post-mortem tax plans to avoid double tax are typically used either alone or together in order to maximize the cash available to beneficiaries of the estate:

- I. Capital loss carry-back - reduces the capital gains tax in the terminal return and results in the estate receiving a dividend
- II. Pipeline – results in a capital gain being reported in the terminal return for the deceased
- III. Bump – increases the ACB of certain types of corporate assets up to their FMV based on the FMV ACB of the shares at death
- IV. Combination plan – combines elements of two or more of the above plans

I. *Capital loss carry-back* - Assuming the Will of the life insured allows the executor to file tax elections and dispose of shares, the executor can make use of the capital loss carry-back found in s.164(6). The capital loss carry-back requires the estate to incur a capital loss in its first tax year which ends one year after the death of the life insured and for the executor to file an election within 90 days of the first tax year of the estate. Other complex considerations must be contemplated regarding the use of s.164(6). Similar planning is available if a qualifying spousal trust owns the shares when the surviving spouse dies.

In order to remove all the assets from the corporation and transfer them to the estate of the life insured, the executor could wind-up the corporation. The movement of assets from the corporation is considered a disposition of the assets being moved at their FMV. This may trigger capital gains or recapture. This payment to the estate is considered a deemed dividend for tax purposes to the extent the FMV of the assets transferred to the estate exceeds the paid-up capital of the shares owned by the estate.

In addition to the deemed dividend calculation, the Act requires a calculation of the capital gains or losses on the redemption of the shares owned by the estate. The redemption is a disposition of the shares for tax purposes such that the estate will recognize a capital gain or loss computed as the FMV of the shares immediately before the redemption less the sum of the deemed dividend and the FMV ACB. The estate realizes a capital loss in the amount of the capital gain reported on the terminal return.

Section 164(6) allows the estate's capital loss to be carried back to the terminal return of the life insured, to be deducted against the capital gain. The estate rules in Budget 2014 restricted the use of the loss carry-back as it can only be used by a "graduated rate estate" (GRE). CRA has stated that GRE-status will apply to all assets in the estate whether probated or not. This seems to allow the capital loss carry-back to apply where the life insured had multiple wills.

The effect is that dividend tax is still payable but the capital gains tax is eliminated. This may not be the best solution because the dividend tax rate and tax in the corporation on selling the assets could be more than 20% higher than the capital gains tax rate. A review of the current personal and corporate tax rates in a specific province is recommended for pursuing a capital loss carry-back strategy.

If life insurance proceeds and the receipt of tax-free capital dividends from the CDA are being used to redeem shares, reduce or eliminate the tax on the shares owned at death, it is important to consider the stop-loss rules. These rules were introduced in 1995 to prevent the complete elimination of tax on shares at death through the use of capital dividends if not enough taxable dividends are received on a redemption of shares. As a result, Finance decided that only 50% of the capital loss would be stopped where capital dividends were used to redeem all the shares. This means that for polices sold after April 26, 1995 you may still use capital dividends as part of the redemption, but the capital loss available for carry-back will be limited when more than 50% of the dividend was a capital dividend. The planning that has subsequently been used to avoid the stop-loss rules is referred to as the "50% solution".

The older policies are grandfathered and under the right circumstances can still be used to completely eliminate the dividend tax by using capital dividends, and the loss carry-back to eliminate the capital gain.

The effect of the "50% solution" is that the first tax, the capital gains tax is eliminated; plus, 50% of the second tax, the dividend tax is eliminated.

II. *Pipeline* - This post-mortem tax plan eliminates the dividend tax on redemption of shares but does not eliminate the capital gains tax on the shares owned at death.

A pipeline is a series of transactions involving a new corporation, use of the FMV ACB, a promissory note and the eventual winding-up of the original corporation and possibly the new corporation. The result is that you eliminate the dividend tax and are left with the capital gains tax.

CRA has ruled favourably on pipeline planning only in certain circumstances. Currently, CRA requires that the business must continue to operate for at least one year for the pipeline to apply. This is an evolving area of interpretation by the CRA and updates should be monitored closely. Based on the current tax rate environment where the rate on capital gains is less than the rate on dividends, it is often the preferred approach. However, if there are assets in the corporation with accrued gains, this planning may not be appropriate on its own and may have to be combined with other planning.

III. *Bump* - This post-mortem tax plan utilizes elements of the pipeline plan and reduces or eliminates the tax on accrued gains on the future sale of the assets inside the corporation.

A bump is complex to implement because it involves a new corporation and an amalgamation or a winding-up. It is restricted to certain types of assets and may not apply or work in all post-mortem situations; however, the idea behind a bump is simple.

As stated before, if the life insured's estate could sell the shares of the corporation, then it would get the sale proceeds tax free because of the FMV ACB. If the estate is not going to sell the shares, then the FMV ACB may be wasted.

Bump refers quite literally to the push down of the FMV ACB from the shares of the corporation to the assets inside the corporation as in "there has been a bump in the ACB of the assets in the corporation". This allows the assets in the corporation to be sold and converted to cash without incurring additional tax. The result is that the capital gains tax on the shares owned at death is still paid on the shares. When used in combination with the pipeline planning, the tax on the gain realized at death is not taxed a second time when assets are sold by the corporation and distributed to the shareholders of the inherited shares.

IV. *Combination plan*
It is possible to use a combination of the individual plans described above to utilize the corporate surplus accounts such as the CDA and refundable dividend tax on hand and if there is corporate owned life insurance. For example, this would be achieved by obtaining dividend treatment with redemptions of certain shares and applying capital gains treatment to the remaining value with the pipeline.

Life insurance and post-mortem planning - As a supplement to post-mortem planning: an insurance policy pays out in cash; there is no tax payable by the corporation on the receipt of death benefit proceeds. The death benefit proceeds over ACB can be paid out as capital dividends. ACB amounts are payable as taxable dividends but the ACB may be quite small in later years as NCPI amounts increase. To the extent taxable assets have to be converted to cash to deposit to an insurance policy, there may be tax payable.

RETIREMENT SOLUTIONS

The CSV of a policy is designed to provide a significant lifetime benefit. Among other things, the CSV of the policy may be used as collateral for a third–party bank loan. When a corporation or an individual receives a collateral loan, the loan is not considered to be a taxable disposition of the interest in the insurance policy by virtue of the definition of "disposition" in s.148(9) as the Act specifically allows "an assignment of all or any part of an interest in the policy for the purpose of securing a debt or a loan" by excluding it from the definition of policy disposition. Therefore, it is understood that the use of the CSV of a policy as collateral is permitted under tax law. This differs from a "policy loan", which is an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of the life insurance policy. In contrast, with a collateral loan the borrower must apply for and meet the third-party lending institution's loan qualification requirements. Availability of a loan from the third-party lending institution is not guaranteed by Equitable Life and is not part of the life insurance contract. The ability to obtain a loan and the terms of a loan are subject to the financial underwriting policies at the third-party lending institution at the time of loan and are subject to change at any time. There may be conditions, fees and costs associated with arranging the collateral bank loan.

It may be possible for an individual shareholder to arrange to receive tax-free collateral loan amounts in retirement, subject to the below comments on shareholder borrowings, by having the corporate owner of the policy guarantee the loan by pledging the CSV of a corporate policy as collateral. Alternatively, the corporation may receive the loan amounts and pay dividends to a shareholder. If the lender allows the loan to be outstanding until death, the death benefit proceeds will be available to pay the loan.

Lending limit - Loan minimums vary by financial institution. Some financial institutions require a minimum collateral loan of $250,000. Subject to the terms of the loan, collateral loans can be fixed yearly amounts or lump sums; interest may be paid annually or capitalized. It is possible to illustrate borrowing based on:

- the start date and projected date of repayment, life expectancy or later
- type of investments in the policy
- the assumed returns from those investments
- the assumed interest rates to be charged on the loan

Typical lending limits* as a portion of the CSV are:

- Universal life insurance: 50% to 90% depending on where underlying investments are.
- Traditional participating whole life insurance: up to 100%.

* Loan minimums vary by third-party lending institution.

Additional terms and features of the loan can be negotiated with the bank, and it is important to recognize when the loan may be called prior to death (for example, if the financial institution no longer wishes to accept the policy as collateral because the loan exceeds the CSV lending limit or certain financial covenants and minimum income requirements are no longer being met.)

SHAREHOLDER BORROWING

Where the shareholder is the borrower, certain precautions should be followed to minimize the risk of an assessment of a shareholder benefit by CRA.

Currently using the CSV of a corporate life insurance policy as collateral for a corporate guarantee on a personal bank loan is one of the strategies used to access the cash value of a corporately-owned life insurance policy.

Recently, CRA and Finance have had concerns with certain borrowing strategies. In 2013 Finance eliminated a well-established lending arrangement called the 10/8, but did not limit other lending strategies. However, Finance has expressed that it will continue to monitor lending arrangements and expand legislation if necessary. Laws and regulations can change in the future, with the potential to impact the ability to use a corporate life insurance policy as collateral security for a personal loan.

Guarantee fees - CRA's position is that a shareholder has received a benefit when the shareholder has used the property of the corporation – this includes use of CSV of a corporate life insurance policy as collateral for a loan. The benefit is the value of the guarantee provided by the corporation. In the past, the CRA has made non-binding comments that where the shareholder is able arrange the loan on the same terms and interest rate without the use of the CSV as collateral there is very little, if any benefit.

The common practice is and should be that the shareholder pays a guarantee fee to the corporation. This guarantee fee should be calculated by a finance professional with knowledge in this specific area. This guarantee fee will be considered taxable income to the corporation.

NOTE: if the Bank were to seize the CSV of a corporate policy in order to re-pay the shareholder's personal loan the tax results could be catastrophic:

- full taxation of the excess of CSV over ACB (if any) in the corporation based on the surrender of the policy
- taxation of the amount of the loan repaid by the policy as a shareholder benefit in the hands of the shareholder; and
- loss of the life insurance benefit

An additional precaution is necessary. If the CSV of a corporate life insurance policy is assigned as collateral for a loan to the shareholder, a significant issue may arise at the time of repayment at death. If the bank receives the death benefit proceeds and uses it to pay for the shareholder loan then it is unclear how the corporation can claim to have received the death benefit proceeds constructively or otherwise. If CRA does not accept that the corporation constructively received the death benefit proceeds and, in fact assesses on the basis the shareholder received the death benefit proceeds then the entire death benefit proceeds can be taxable as a shareholder benefit. The corporation will not get an addition to its CDA for the full amount of the death benefit (it will be reduced by the amount of the loan paid.)

To avoid this, it is advisable that on the death of the life insured, the corporation approach the life insurance company and the bank and instruct the life insurance company to delay paying out the death benefit until appropriate arrangements can be made. The executor of the life insured's estate can request the bank to accept alternative collateral long enough so that the death benefit proceeds of the life insurance policy may be received by the corporation, followed by payment to the shareholder as a capital dividend. The shareholder would repay the loan upon receipt of the dividend. This strategy assumes the provisions of the bank loan allow alternative collateral at time of repayment. The strategy also requires sufficient appropriate alternative collateral at time of repayment.

Retirement Compensation Arrangement (RCA) - Many innovative tax plans have been developed for the purpose of deferring compensation into retirement. The RCA rules are complex and beyond the scope of this guide. The essential element of the RCA rules is that where an employer has an obligation to provide a retirement benefit in the future (which is not a pension) then that benefit should be taxed now. The RCA tax can be 50% plus penalties and interest. It is worth clearly stating that if there is any possibility that the CSV of a life insurance policy used as collateral in a borrowing arrangement may be interpreted as part of a retirement benefit an employer is obligated to make as compensation for past service – then the advice of a tax specialist should be obtained.

CORPORATE BORROWING

The corporation may borrow using the CSV of a life insurance policy as collateral and pay taxable dividends to the shareholder as an alternative to shareholder borrowing. While this corporate loan strategy may cause the shareholder to incur dividend tax, there are a number of significant tax advantages.

No shareholder benefits - There is no shareholder benefit to consider. This means no need for a guarantee fee or risk of a shareholder benefit assessment for an improper guarantee fee. Further, there is no risk that at the time of repayment the shareholder may have to pay tax on the full amount of the loan as a shareholder benefit.

The interest on the loan, as shown in the illustration, may be deductible against corporate income to the extent that dividends are paid from accumulated earnings. CRA administratively allows interest to be deducted where the loan is used to "fill the hole" left by the dividend. In addition, the NCPI (net cost of pure insurance) may be deductible against corporate income on a pro-rata basis. However, these deductions only have value if the corporation has taxable income to use the deductions.

The corporate dividends paid with the loan proceeds are taxable when paid to the shareholder. There may already be a plan to redeem shares over time to reduce total share value on death. There may also be Refundable Dividend Tax on Hand (RDTOH), CDA balances, losses or lower tax rates available. These details make it essential to involve the tax professional in the discussion.

The tax savings from the total of the loan, deductible interest and NCPI amounts combined with the decreased fair market value of the shares of the corporation reduce the capital gains tax in the final return.

At death, when the loan is repaid, the corporation gets an addition to its CDA for the full death benefit less the policy's ACB. There is no deduction for the amount of the loan repaid. This results in a balance in the corporation's CDA from the life insurance proceeds after the loan is repaid. This may mean that other assets or future earnings can be distributed to shareholders as tax-free capital dividends.

The repayment of a corporate loan is much easier than a shareholder loan in that it can be paid directly without additional collateral; and, the payment of a corporate loan does not require the use of capital dividends; meaning that the entire capital dividend account is still available for other purposes.

The choice between a personal loan and a corporate loan can be made at the time of the loan or reorganized at a later date. This decision will be based on the circumstances and tax situation of the shareholder and the corporation at the time the loan is made as well as the projected future circumstances when repayment is made. A tax professional will be helpful in illustrating the tax numbers behind the calculations so that more fully informed decisions can be made.

CONCLUSION

When you consider the tax benefits of an exempt life insurance policy, combined with the benefits of CSV loans paid at death, and the reduced capital gain and dividend tax to the estate, then life insurance can indeed be called the "preferred" solution for your *Corporate* estate transfer and retirement needs.

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