FEDERAL BUDGET 2016

BY JAMIE GOLOMBEK

Corporate Measures

How tax changes will affect corporate-owned life insurance policies

The 2016 federal budget has made some amendments to how business owners can use corporate-owned life insurance policies. I'll explain two common strategies used today and the measures the budget proposes.

HOLDCO-OWNED INSURANCE WITH OPCO AS BENEFICIARY

The first strategy involves corporate-owned life insurance where the owner of the policy is a holdco and the beneficiary is the opco. The general rule is that the death benefit from a life insurance policy is generally received on a tax-free basis, whether owned personally or in a corporation. With corporately owned life insurance, the Capital Dividend Account (CDA) may also allow part, or all, of the death benefit to be distributed from the corporation to the shareholder(s) on a tax-free basis.

To the extent that there is a positive balance in its CDA at any point in time, a corporation may elect to pay a capital dividend that is generally tax-free to the shareholder(s). Amounts added to the CDA include the life insurance death benefit less the adjusted cost basis (ACB) of the policy. The lower the ACB of the policy, the larger the CDA addition from the insurance death benefit. The ACB of a life insurance policy generally equals the total of premiums paid, less the net cost of pure insurance (NCPI), which refers to the pure mortality cost.

An oft-recommended strategy sought to effectively reduce the ACB of the policy to zero, is to have the premiums paid by a party other than the beneficiary. For example, let's say we have a corporately owned life insurance policy with the following attributes: $100,000 of premiums has been paid; the cumulative NCPI is $10,000; and the death benefit is $1 million. Suppose Corporation A owns the life insurance policy, pays the premiums, and is the beneficiary. The ACB of the policy would, therefore, be $90,000 ($100,000 premiums - $10,000 NCPI). When Corporation A receives the $1 million death benefit, the CDA addition would be $910,000 ($1 million death benefit - $90,000 ACB). Corporation A could pay a capital dividend of $910,000 to its shareholder(s); however, the remaining $90,000 could only be distributed as a taxable dividend.

Alternatively, suppose Corporation A (holdco) owns all the shares of Corporation B (opco) and Corporation A owns the life insurance policy and pays the premiums, but Corporation B is the beneficiary. The ACB of the policy for Corporation B would be $0, since it pays no premiums. As a result, when Corporation B receives the $1 million death benefit, the full amount ($1 million death benefit - $0 ACB) would be added to its CDA. Corporation B could then pay a capital dividend of $1 million to Corporation A that, in turn, could pay a $1 million capital dividend to its shareholder(s). Simply by separating the owner from the beneficiary, the taxable dividend of $90,000 becomes a capital dividend. It should be noted that there are valid non-tax reasons for establishing the ownership and beneficiary in this way — for example, to protect the insurance policy from creditors of Corporation A.

Although there was always the potential for the Canada Revenue Agency to challenge this arrangement using current tax law, particularly where there was no business purpose for separating the owner and beneficiary of the policy, Budget 2016 introduced specific measures eliminating this planning by proposing that the amount added to the CDA will take into account the ACB of any policyholder, even if the policyholder and beneficiary of the policy are different. Information-reporting requirements will also apply where a corporation is not a

PHOTO: ISTOCKPHOTO

policyholder but is entitled to receive a death benefit.

The budget measures will apply when death benefits are received as a result of a death occurring on or after March 22, 2016.

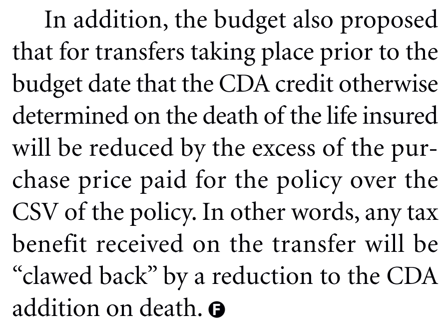
TRANSFER OF LIFE INSURANCE FROM A SHAREHOLDER TO A CORPORATION

The second strategy that's come under attack by the budget involves transferring a personally owned life insurance policy to a non-arm's-length corporation where the policy had a fair market value (FMV) — as determined by an actuarial valuation — that was higher than its cash surrender value (CSV). This may occur where the cost of buying a new policy would greatly exceed the cost of continuing to pay the premiums on the old policy, perhaps due to advanced age, poor health, or decreased life expectancy of the insured individual.

For example, suppose a shareholder owns a policy with a death benefit of $1 million, an ACB of $100,000, and CSV of $250,000. The insured individual has a shortened life expectancy and an actuary has determined that the FMV of the policy is $900,000. The shareholder could transfer the policy to his or her corporation in exchange for cash or a promissory note equal to the policy's FMV of $900,000. Prior to the changes announced in the 2016 federal budget, because the parties were not dealing at arm's-length, the policy would be deemed to be transferred for proceeds equal to its CSV of $250,000. The shareholder would only pay tax on $150,000 (the difference between the CSV of $250,000 and the ACB of $100,000); the remaining $750,000 ($900,000 - $150,000) could be received tax-free by the shareholder.

The ACB of the life insurance policy to the corporation is equal to the deemed proceeds of $250,000 (and not the FMV of $900,000). This is beneficial because upon death of the insured individual, $750,000 (the death benefit of $1 million, less the adjusted cost basis of the policy) can generally be paid out tax-free as a capital dividend. (In some cases, however, this could also have negative tax consequences if the CSV of the policy continues to grow into the future and the policy is surrendered, as this will result in a higher taxable gain to the corporation than would otherwise be the case, if the amount paid for the policy was recognized.)

The CRA had previously confirmed that although this tax plan worked on a technical basis, it didn't like it and had referred the issue to the Department of Finance. The 2016 federal budget shut down this strategy by making the shareholder's proceeds of disposition, and the corporation's ACB, equal to the FMV of consideration given for the policy for all policy transfers that occur on or after March 22, 2016.



In addition, the budget also proposed that for transfers taking place prior to the budget date that the CDA credit otherwise determined on the death of the life insured will be reduced by the excess of the purchase price paid for the policy over the CSV of the policy. In other words, any tax benefit received on the transfer will be "clawed back" by a reduction to the CDA addition on death. F

JAMIE GOLOMBEK, CPA, CA, CFP, CLU, TEP, is the managing director, Tax & Estate Planning, with CIBC Wealth Strategies Group in Toronto. He can be reached at Jamie.Golombek@cibc.com.

FIELD LEADERSHIP SERIES

SYSTEMS FOR SUCCESS

FINDING THE RIGHT PEOPLE — June 22, TORONTO, ON

KEEPING THE RIGHT PEOPLE — June 22, TORONTO, ON

BUILDING HIGH-PERFORMANCE ADVISOR TEAMS — Nov 17, TORONTO, ON

Each workshop is worth 7.5 Institute-accredited CE credits.
AIC credits also available.

Register today at gamacanada.com/leaders