



Life insurance shares – An overview

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CALUreport

AUGUST 2021

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Introduction²

In recent years, corporate-owned life insurance has become an important planning tool in meeting the estate planning objectives and goals of business owners. Often in a family business setting, corporate-owned life insurance is purchased to fund tax liabilities arising on the death of a business owner, to facilitate business succession objectives and to enable estate equalization goals. Life insurance shares are yet another tool which may be used in serving these objectives. In general, a life insurance share can accomplish the streaming of life insurance proceeds and related capital dividends to the holder of the share.³

This article explores the general attributes and characteristics of these shares, the main situations where they may be used, what is accomplished by the use of them; and the tax and non-tax issues associated with their use. The main question relating to life insurance shares is one of valuation at the time of issue, and one of the main tax risks in structuring life insurance shares is the potential shifting of value through inadequate consideration being paid for the shares, and/or corporate impoverishment resulting in benefit conferral.

Life insurance share attributes and characteristics

Life insurance shares, like any class of shares, must be authorized share capital in a corporation's articles of incorporation. If life insurance shares are not already contemplated in the articles, an amendment would be needed to create them as a new class of preference shares.

In general, life insurance shares are normally non-voting and non-participating in the profits of the corporation. The redemption amount of the life insurance share typically tracks life insurance death benefit proceeds and/or the increase in the capital dividend account⁴ (CDA) arising from life insurance received by the corporation when a person whose life is insured dies. The life insurance share redemption amount may track to the proceeds of a specific life insurance policy, or any life insurance policies held by the corporation. The share attributes would also normally entitle the holder to be paid the redemption amount as a tax-free capital dividend⁵ to the extent of any CDA credit arising from the life insurance proceeds. However, this may not always be the case. For example, in a situation where there are US persons who are holders of life insurance shares, a right to receive capital dividends may not be an attribute of the shares.

Prior to the death of a life insured person, life insurance shares may or may not entitle the holder to receive a redemption amount equal to a life insurance policy's cash surrender value (CSV) should the policy be surrendered by the corporation or on a winding up of the corporation. The corporation may or may not have an option or right to redeem the shares during the life of the insured person. The life insurance share holder may or may not have an option or right to call for the redemption of the share during the life of the person whose life is insured. The amount and timing of the payment of any redemption amount in respect of the exercise of this type of option or right, if available, may also be prescribed by the share attributes. In some cases, payment of the redemption proceeds may be deferred until after the death benefit is paid to the corporation under the policy.

1 The author would like to thank Diane Hamel, CPA, CGA, TEP, Assistant Vice President Tax & Estate Planning, Manulife for detailed review and comments on this article.

2 This article was originally published in 2021 Insurance Planning Vol. XXVI no.2 and is republished with the permission of Thomson Reuters. Modifications were made to reflect the 2021 CLHIA CRA Roundtable responses relating to life insurance shares.

3 There may be other ways to accomplish similar estate and tax planning goals such as the use of a shareholders' agreement to define entitlement to life insurance proceeds. Life insurance shares may also be contemplated in a shareholders' agreement to provide another form of governance in respect of the shares.

4 Subsection 89(1) definition of "capital dividend account" in the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act". Unless otherwise stated, statutory references in this article are to the Act.

5 Subsection 83(2).

Life insurance products may or may not have CSVs. For insurance products that have CSVs, the style of product and death benefit pattern can result in the CSV contributing in different ways to the ultimate death benefit that is payable. For universal life (UL) policies, the policy's CSV may be added to the death benefit amount (face plus UL policies), or, the CSV may represent more and more of the fixed death benefit that is ultimately payable (level face UL). Some UL policies actually offer both types of cash values. Participating (Par) whole life insurance policies have CSVs, but these do not add to the death benefit payable (as is the case with face plus UL). Policy dividends can be used to purchase paid-up additions which add to the base level of coverage and can create a growing death benefit. Paid-up additions have CSVs associated with them similar to level face UL policies. CSVs that are associated with Par policies, whether guaranteed or the result of policy dividends, are only accessible during life. This means that the death benefit payable under a Par product is, in essence, an initial coverage that provides a level death benefit plus additional amounts of level death benefit coverage that is added to the base level of coverage with each policy dividend, if policy dividends are deployed in this manner. The type of corporate owned life insurance policy may therefore create life insurance share drafting complexities.

The share attributes, rights and entitlements may be customized to the specific circumstances to contemplate the goals and objectives of a business owner and their family.⁶

Normally, life insurance shares are issued at a time when there is no life insurance yet in place. This would support the argument that the life insurance share can be subscribed for nominal consideration. If issued to a sole shareholder of the corporation, there should be no particular valuation concerns. However, when issuing life insurance shares to someone other than the sole shareholder such as other family members or a family trust, one could question if nominal consideration is sufficient, especially where the corporation's existing assets/retained earnings are used

to purchase a life insurance policy which immediately results in growing cash values in the policy.

Where there is life insurance already in place and the life insurance shares are issued to a shareholder of all of the outstanding shares of a company, there should generally be no concern relating to valuation of the newly issued life insurance shares. This is due to the fact that the sole shareholder would continue to retain full ownership, and with it, all the value of the underlying assets of the corporation would be attributable to the sole shareholder. So long as this remains true there should be no particular valuation problem with the issuance of the life insurance shares even at a nominal value at the time of a reorganization of share capital. However, if there is existing insurance at the time the life insurance shares are issued to other family members, the subscription price for the newly issued life insurance share would need to reflect the value of the life insurance that the life insurance share tracks. The only situation in which this may arguably not be the case is where a freeze is done at the time of the issuance of the life insurance shares and the existing life insurance policy's value is reflected in the redemption amount of the freezer's preference shares.

Use and objectives of life insurance shares

Estate equalization is a common problem in family business succession. The use of life insurance shares can enable corporate-owned life insurance proceeds and related capital dividends to be streamed to non-successor family members while the business is passed on to successor family members. In a typical estate freeze situation, the freezer takes back preference shares representing the fair market value of the company while common shares are issued to successors directly, or to a family trust of which the successors are beneficiaries. Life insurance shares may also be issued to a family trust which includes non-successors as beneficiaries or directly to non-successors at the time of a freeze.

⁶ However, as discussed below, care must be taken in structuring the share attributes to minimize the potential of adverse tax consequences when the shares are issued or in the future.

Where there is no freeze and common shares are held until death, the issuance of life insurance shares to the common shareholder can accomplish the streaming of corporate-owned life insurance proceeds to the ultimate holder of the shares. The deceased common shareholder may, by Will, pass life insurance shares to non-successors and common shares to successors.

It is also possible to stream capital dividends arising from corporate-owned life insurance proceeds to Canadian residents who can benefit from the characterization of the dividends received as capital dividends. With many families having cross-border connections, planning may contemplate which beneficiaries can best use the beneficial tax attributes of the insurance proceeds when structuring post-mortem corporate distributions. In this example, the life insurance shares could pass to the Canadian resident beneficiaries of a deceased testator.

Life insurance shares can be issued to a business owner to fund the tax liability arising from the deemed disposition of their shares at fair market value on death.⁷ The executor is able to cause the corporation to redeem the life insurance shares without any conflict of interest that might arise due to the executor also being a director of the corporation.

Another example of the use of life insurance shares is where two siblings own a successful business and want the shares of the business to pass to the other sibling on the first of their deaths. However, they don't want to fund a buy-out of each other's interest by using life insurance. Rather, they want to pass the shares by Will to the surviving sibling but have the corporate owned life insurance fund the capital gains tax suffered by the first-to-die sibling. Life insurance shares would entitle the deceased holder's estate to life insurance proceeds (via the payment of a capital dividend) to pay the tax liability arising on death, with the common shares passing to the surviving sibling.

The use of life insurance shares can also enable the payment of corporate insurance proceeds to the

deceased's estate to settle tax liabilities and other estate bequests. By having a separate class of life insurance shares, there would be no concern in meeting the conditions for a spousal rollover⁸ to a testamentary spousal trust of shares of a corporation that owns life insurance on the deceased. There could be no argument that anyone other than the spouse received or otherwise obtained the use of the corporate shares since the life insurance proceeds would be paid to the estate through the life insurance shares independently of the shares received by the spouse trust.

In the context of a buy-sell between related parties, life insurance shares may also be useful to assist the executor of a deceased shareholder when transacting with the surviving shareholder. For example, consider a simple situation where two siblings have a buy-sell agreement and agree to fund the purchase of each other's shares with corporate-owned life insurance. Separate life insurance shares are issued to each sibling which track the corporate owned life insurance on the other sibling's life. With the use of life insurance shares, insurance proceeds can be paid to the survivor to purchase the shares from the deceased's estate. From the executor's point of view, using life insurance shares pre-empts any questions and any adverse tax consequences⁹ regarding the fair market value of the shares sold to the surviving sibling since the insurance proceeds payable to the corporation on the sibling's death would clearly not be part of the value attributable to the deceased's shares.

In the context of a family business where an inter-generational transfer of the business has been facilitated by an estate freeze, life insurance shares can be a manner in which the freezor can ensure that corporate-owned insurance on the lives of the children is provided to their branches of the family. Under such a freeze, the freezor receives frozen preference shares and the children and grandchildren would be beneficiaries of the family trust holding the newly issued common shares. Life insurance shares to stream life insurance proceeds

7 Subsection 70(5).

8 Subsection 70(6).

9 Section 69.

of corporate-owned life insurance on the lives of the children could be issued to the family trust, with those shares being distributed to the grandchildren or to the children and passed by their Will to their own children (the grandchildren).

As discussed, in general life insurance shares are issued prior to the purchase of any life insurance by the corporation. There are some circumstances involving existing insurance which may lend themselves to the use of life insurance shares. One narrow example of such a situation could involve an existing testamentary spouse trust which holds all of the shares of a corporation. Amongst its assets, the corporation owns a joint-last-to-die life insurance policy on a husband and wife (Mr. A and Ms. A, where Mr. A is already deceased). On the death of Ms. A, the spouse trust is required to distribute the trust assets to multiple trusts in favour of the grandchildren. This planning had the effect of by-passing the parents of the grandchildren. With the change in the tax regime for testamentary trusts¹⁰ which would subject income retained in these successive trusts to top marginal rate taxation, the planned use of multiple testamentary trusts could become punitive. Assume the spouse trust's terms provide an unlimited power to encroach on capital in favour of Ms. A and to carry out reorganizations, make elections under the Act and otherwise carry out tax planning. The trust could therefore carry out a reorganization of capital, creating life insurance shares and encroaching on capital to distribute the life insurance shares to Ms. A. Ms. A could then give the life insurance shares in her Will to her own children - the parents of the grandchildren. This would allow the life insurance proceeds to be paid outright and not be held in multiple successive testamentary trusts for the grandchildren. While this modifies the original estate plan, it does not change the tax liability arising upon the death of the spouse.

In summary, life insurance shares allow for ease of administration in respect of life insurance proceeds

received by a corporation that are intended to be distributed from the corporation. As a right or entitlement under the life insurance share, the insurance proceeds may be distributed to satisfy tax liabilities of a business owner, equalize estate assets where some beneficiaries are successors to the business and some are not, or to carry out a different distribution of an existing inheritance. Life insurance shares enable the proceeds and related capital dividends to be streamed to appropriate beneficiaries ensuring that those shareholders that can benefit from receipt of capital dividends receive them, while those shareholders who cannot, do not.

Tax commentary relating to life insurance shares

CRA INTERPRETATIONS RELATING TO LIFE INSURANCE SHARES

As noted, the main tax issue relating to life insurance shares involves a question of valuation. If the consideration paid for the shares is inadequate, will there be a shareholder benefit¹¹ conferred on the holder of the share or the existing shareholders at that time? Even if the consideration represents the fair value of the shares upon issuance, will the company's existing assets/surplus/retained earnings be used to fund a life insurance policy that results in an erosion of the value of the common shares? And is there some direct or indirect benefit being conferred, resulting from that erosion of value? What is the value of the life insurance share vis-a-vis the other classes of shares at the time of death in relation to the life insurance policy held by the corporation?

Some of these questions have been touched on by the existing Canada Revenue Agency (CRA) commentary addressing life insurance shares. However, it is difficult to extrapolate from the existing commentary to all situations involving life insurance shares since the share attributes may be drafted with particular rights and obligations tailored to the specific fact

10 Bill C-43 enacted on December 15, 2014, effective January 1, 2016, removed graduated rate taxation for all existing and newly created testamentary trusts (as well as grandfathered pre-June 18, 1971 *inter vivos* trusts) other than the "graduated rate estate" and "qualified disability trusts".

11 Subsection 15(1).

situation. The facts described in the CRA commentary may not be totally similar to the facts that any particular life insurance share situation involves. Notwithstanding that, it is helpful to review the commentary as a starting point.

Question 12¹² at the 2005 APFF Conference presented two different scenarios. Scenario A involved the purchase of a life insurance share for \$1 by the son of the 100 per cent common shareholder. The share was non-voting, non-participating, redeemable for \$1 at the discretion of the corporation and entitled the holder to receive a capital dividend equal to the proceeds of the life insurance policy received by the corporation when the 100 per cent common shareholder dies. After the issuance of the share, a Term-to-100 policy with no cash value on the life of the 100 per cent common shareholder is purchased by the corporation with the corporation as beneficiary. The CRA was asked to confirm that the fair market value of the life insurance share was \$1 at the time of issue. The CRA indicated it would not express an opinion on the fair market value of the share.

A subsequent APFF Conference question attempted to gain further insight on the question of fair market value of life insurance shares on the death of the holder (also the common shareholder) and was met with a similarly non-committal response.¹³

Scenario B of Question 12 at the 2005 APFF involved life insurance shares with the same attributes as described in Scenario A, however, the 100 per cent common shareholder acquires the life insurance share for \$1. The life insurance subsequently purchased by the corporation has a CSV by the time of the 100 per cent common shareholder's death. The question posed was whether the policy's CSV would be taken into account in valuing the deceased's common shares or their life insurance share. The CRA's response was as follows:

Subsection 70(5.3) of the ITA does not specify how to distribute the cash surrender value of a life insurance policy between different categories of shares. Generally, we are of the opinion that it would be reasonable to distribute the cash surrender value of a life insurance policy between the different categories of shares based on the rights and conditions attached to them, in the same way as the overall value of a business is distributed between the different categories of shares in circulation. To be able to answer the question definitively, it would be necessary to obtain a description of all the rights and conditions attached to the different categories of shares of the corporation. Subject to obtaining additional information, it appears that the overall value of the corporation that would be attributed to the special share immediately before the death would be nominal. Accordingly, the value of the common shares immediately before the death would take into account almost the entire cash surrender value of the life insurance policy.

Consider this response in the following context. A shareholder, owning both common shares and life insurance shares, has remarried after the death of a spouse (or prior marriage breakdown). The shareholder plans to roll over the common shares to their new spouse or spouse trust, while still distributing the life insurance shares to children of the first marriage. On the transfer of the common shares to the surviving spouse there would be no capital gains tax liability in respect of the cash value of the policy since that value would be part of the common shares rolling over to the spouse. The life insurance shares would therefore have no value for purposes of the transfer to the children of the first marriage, and

12 2005-0138361C6 dated October 7, 2005.

13 2008-0286151C6 dated October 10, 2008, dealt with the valuation of the shares of a corporation including life insurance shares. There was a sole shareholder of all the common shares. The corporation was to purchase and be beneficiary under a term life insurance policy with no CSV on the life of the shareholder. A class of shares is added to the corporation's authorized capital that are non-voting, non-participating, and redeemable at the option of the holder before death at the issue price of \$1 and after death at the issue price plus the proceeds of the life insurance policy. The CRA would not provide an opinion of value of the shares on death and could not definitively conclude that the fair market value of the life insurance share would be its issue price.

again no capital gain would arise on death in respect of those shares.

In Question 11¹⁴ the CRA was asked to comment on a situation where the taxpayer was the sole shareholder, holding all of the common shares of a private corporation. Life insurance shares were added to the corporation's authorized share capital and the corporation subsequently acquired a UL policy on the taxpayer's life. The corporation is the policyholder and beneficiary of the policy. The characteristics of the insurance shares were described as follows:

- a. they are non-voting;
- b. they do not entitle the holder to any participation in the corporation's profits, other than the dividend described in paragraph (c) below;
- c. they entitle the holder to a dividend in an amount corresponding to the death benefit payable under the policy. This dividend may only be declared, however, after the taxpayer's death;
- d. they are redeemable at the holder's option:
 - i. at any time before the taxpayer's death, for an amount corresponding to the cash surrender value of the policy at the time of redemption. Payment of the redemption amount is, however, deferred until the corporation receives the policy's death benefit;
 - ii. at any time after the taxpayer's death, for an amount corresponding to the difference between the amount of the policy's death benefit and the amount of the dividend declared on them, if any. Once again, payment of the redemption amount is deferred until the corporation receives the policy's death benefit.
- e. they are redeemable at the corporation's option at any time after the taxpayer's death, for an amount corresponding to the difference between the amount of the policy's death benefit and the amount of the dividend declared on them, if any, payment of the redemption amount being,

however, deferred until the corporation receives the policy's death benefit;

- f. the cash surrender value described in paragraph (d) above is also the amount to which shareholders holding the insurance shares are entitled when the corporation is liquidated.

The taxpayer's adult child subscribes for one life insurance share for \$1 and subsequently the policy is acquired by the corporation.

In applying subsection 70(5.3) of the ITA, CRA was asked to confirm that immediately before the taxpayer's death, the policy's CSV does not increase the fair market value of the common shares held by the taxpayer, since the value is reflected in the redemption amount of the insurance share held by the taxpayer's adult child.

The CRA commented that given the facts as provided, it would not be unreasonable to allocate the amount of the policy's CSV immediately before death to the insurance shares and that the value of the common shares held by the taxpayer in this situation would not take into account the CSV of the policy on the life of the taxpayer.

To understand implications of this response, consider the following example:

Dad owns the common shares of DCo with nil adjusted cost base (ACB) and paid-up capital. At the time of death, the corporation has \$1 million of assets (for simplicity, with no accrued gains after death – excluding the value of any corporate life insurance policies) and a life insurance policy with a total death benefit of \$1 million, a CSV of \$500,000 and no adjusted cost basis. Assume a capital gains tax rate of 26% and dividend tax rate of 45%.

Where life insurance shares are owned by the children and Dad owns common shares, Dad will have a deemed disposition of the common shares at death¹⁵, resulting in a capital gain of \$1 million and taxes payable on the terminal return of \$260,000. The life insurance death

14 2005-0138111C6 dated October 7, 2005.

15 Supra note 7.

benefit of \$1 million will be paid to the children via a tax-free capital dividend. Dad's estate can do a pipeline and ACB bump to extract the remaining \$1 million from the company with no additional taxes payable and preserving the capital gains tax rate.

Without life insurance shares, Dad will have a deemed disposition of the common shares at death, resulting in a capital gain of \$1.5 million (the CSV of the life insurance is included in the fair market value immediately before death¹⁶). Dad's post-mortem plan in this case would likely involve, paying a tax-free capital dividend equal to \$500,000. The assets remaining in the corporation equal the ACB of the common shares. Shares equal to two times the remaining CDA would then be redeemed (50% solution avoiding the stop-loss rules¹⁷) resulting in a \$500,000 tax-free capital dividend and a \$500,000 taxable dividend and tax payable of \$225,000 (\$500,000 X 45%). The redemption also results in a capital loss of \$1 million that can be carried back to Dad's terminal return¹⁸, leaving a capital gain of \$500,000. This results in \$130,000 in tax payable on the terminal return. A pipeline and ACB bump would be done to extract the remaining \$500,000 to preserve the preferential capital gains treatment on that amount. Based on the above example, the life insurance shares result in \$95,000 less tax.

These questions expose differing results based on the nature of the share attributes and point to tax efficiencies which may not have been envisaged by the CRA when it responded in the 2005 technical interpretations. When valuing the shares of a deceased shareholder of a corporation holding corporate-owned life insurance, it is clear that subsection

70(5.3) applies and that it is the CSV that is to be used in valuing the life insurance policy. However, whether, or the extent to which, that CSV is allocated to the deceased shareholder's shares is not addressed by subsection 70(5.3). As recently confirmed by the CRA, subsection 70(5.3)¹⁹ is a valuation rule not an allocation rule.

With this in mind, a question was posed at the CLHIA CRA Roundtable in May 2021 asking for confirmation that the 2005 APFF Question 11 is still the position of the CRA. The CRA confirmed these prior interpretations relating to the allocation of the life insurance policy's CSV across different classes of shares. However, they were careful to state that their views were only relevant in the context of subsection 70(5.3) and only where the share attributes were as specifically described in these scenarios²⁰. This is positive since it affirms their views continue to apply as stated in relatively older technical interpretations. These comments are helpful for purposes of allocating the deemed value of the life insurance policy (the policy's CSV) on death as determined under subsection 70(5.3) between the common shares and the life insurance shares in the specific context of the share attributes in these scenarios.

More recently, life insurance share planning has been combined with the corporation borrowing 100 per cent of the premium to purchase a high-CSV par whole life insurance product²¹. It is argued that the borrowing would be a liability, reducing the value of the company. This combination of leveraging with the use of life insurance shares has the potential effect of not only creating tax efficiency for the owner of the common shares (due to the policy's cash value not being viewed as contributing to the value of the common shares on the deemed disposition on death) but also reducing the value of the common

16 Subsection (70(5.3).

17 Subsection 112(3.2).

18 Subsection 164(6).

19 2020-0842191C6 dated July 8, 2020 (CALU 2020 CRA Roundtable).

20 2021-0884291C6 dated May 19, 2021.

21 Paragraph 20(1)(c) generally permits the deduction of interest on borrowed money used for the purpose of earning income from a business or property. However, interest paid on borrowed money that is used to acquire a life insurance policy is specifically excluded from being a deductible expense.

shares by the amount of the loan. This could reduce or eliminate the capital gains tax exposure on the common shares that would otherwise arise on death. By having the corporation borrow to buy the life insurance, it is argued that there is a reduction in corporate value by the loan amount, while at the same time all the cash value of the life insurance is accreting to the life insurance shareholder. Again, one must question if this correctly allocates values, and in this case the liability to the common shares when it is the life insurance policy itself that is the security for the borrowing. Should the liability and asset (CSV) be aligned with the life insurance share in this instance? Or could the CRA challenge this arrangement on the basis that value is being shifted from the corporation to another person with the concurrence of other shareholders?

Notwithstanding the positive affirmation of the CRA's earlier comments relating to life insurance shares, there remains a significant "elephant in the room". This new CRA interpretation does not answer the question of whether these shares could result in the conferral of a benefit on the owner of the life insurance share due to inadequate consideration being paid for that share or the impoverishment of the corporation when premiums are paid by it.

BENEFIT CONFERRAL AT THE TIME OF ISSUANCE OF A LIFE INSURANCE SHARE AND VALUE SHIFTING

Where a corporate-owned life insurance policy already exists, the issuance of a life insurance share could give rise to a shareholder benefit to the holder if the price that is paid for the life insurance share by the holder does not represent the share's fair market value which should in turn reflect the fair market value of the underlying life insurance policy. Where the holder of the life insurance share is otherwise the sole shareholder of the corporation, there should be no issue as no corporate value is being "shifted" to another shareholder. But where the life

insurance shareholder is someone other than the common shareholder, benefit conferral and value shifting is a concern.

Although not directly on point the CRA has provided some guidance in the context of discretionary dividend shares issued for nominal consideration.²² The CRA confirmed that no indirect benefit would be conferred²³ provided that on the payment of a dividend the shareholder has no pre-existing entitlement to the dividend and proper consideration was given for the shares. However, the CRA stated that a shareholder benefit²⁴ could arise on the issuance of the discretionary dividend share or alternatively, the existing common shareholder may be seen to have disposed of a right, interest or right to dividends. In the context of the issuance of a life insurance share, this position may have relevance even if no life insurance exists at the time of issuance of the life insurance share, if the common shareholder's share value is subsequently depleted as a result of the purchase of the policy (for example, if existing retained earnings are used to pay premiums). Is there a shifting of value away from the common shareholder by using existing value, earnings or assets to purchase life insurance that will accrete to someone other than the common shareholder? However, provided funding for life insurance premiums comes from post life insurance share issuance earnings, assets or value, arguably there should be no cause for concern. This is akin to the tax benefit analysis that is performed on a freeze with existing value represented by the frozen preference shares and with all future growth accruing to the common shares, and where distributions on the common shares cannot be made if such distributions diminish the value of the frozen preference shares.²⁵

DEATH OF A HOLDER OF LIFE INSURANCE SHARES – NOT THE LIFE INSURED

In the CRA commentary relating to life insurance shares, often the holder of these shares is a child

22 2016-0626781E5 dated March 14, 2016.

23 Pursuant to subsection 56(2).

24 Supra note 11.

25 2008-0285241C6, dated April 22, 2009.

of the sole common shareholder of a corporation. Where the holder of a life insurance share predeceases the life insured under a corporate-owned life insurance policy, the life insurance share would be deemed to be disposed of at its fair market value. Subsection 70(5.3) would be applicable in determining the value of any corporate-owned life insurance held by the corporation on the shareholder and those related to the shareholder at CSV. The question here is, once again, based on the attributes of the specific life insurance shares, should the CSV of the life insurance policy to which the shares relate be taken into account in valuing the life insurance share for these purposes? The CRA has not provided much guidance on how to determine the fair market value of a life insurance share in its commentary. While the share could be passed to a spouse or spouse trust via the holder's Will on a rollover basis, this may not be the intended recipient of the life insurance proceeds. Issuing life insurance shares to a family trust may be a solution to this issue to allow the indirect distribution of insurance proceeds to other family beneficiaries should the holder predecease the life insured.

DISTRIBUTION OF CDA – SPECIFIC ANTI-AVOIDANCE PROVISION

It is worth noting that in respect of distributing CDA there is an anti-avoidance provision that would deem a dividend which would otherwise be a capital dividend to be a taxable dividend where the share is acquired in a transaction or series one of the main purposes of which was to receive the dividend.²⁶ However, this provision does not apply where the source of capital dividends distributed is life insurance proceeds.²⁷

Also, the CRA has provided the following commentary in a slightly different context, but which relates to the ability to stream capital dividends to particular shareholders:

Subsection 83(2.1) of the Act could be considered applicable in certain reorganizations or conversions done to allow shareholders to receive capital dividends. However, subsection 83(2.1) of the Act is generally not considered applicable in situations where the purpose is to pay capital dividends to taxpayers who were already shareholders. Thus, the payment of the capital dividend account to certain shareholders would generally not be considered abusive for the purposes of subsection 245(2) of the Act if subsection 83(2.1) of the Act did not otherwise apply.²⁸

TAX ON SPLIT INCOME²⁹ (TOSI)

Where the holder of a life insurance share is not active in the business and receives taxable dividends, they could be subject to TOSI, if no exclusion applies. However, the TOSI rules would not apply to the payment of a capital dividend arising from the receipt of insurance proceeds.

Non-tax issues associated with the use of life insurance shares

CREDITOR ISSUES

Corporate-owned life insurance is an asset of the corporation and would be subject to claims by its creditors. Life insurance shares will only accomplish a distribution of life insurance proceeds to the holder of the share if the insurance exists as the time of death of the person whose life is insured. A policy with CSV may be looked to by creditors in the event the corporation experiences financial difficulties.

FAMILY LAW - RELATIONSHIP BREAKDOWN OF THE HOLDER

In family law matters, valuation of assets can become a matter of dispute. It is unclear how a family law court would view life insurance shares held by

26 Subsection 83(2.1).

27 Subsection 83(2.3).

28 2000-0026615-T dated November 30, 2000.

29 Section 120.4.

a spouse at the time of marriage breakdown. The particular share attributes and rights should be examined, and value may be assessed differently in the context of a matrimonial dispute than it may be for income tax purposes.

MINORITY SHAREHOLDER RIGHTS

Certain basic shareholder rights are enshrined in corporate law statutes. The holder of a life insurance share, as a minority shareholder of a corporation, may have a say in certain fundamental business decisions even though the shares themselves may have no voting rights.

Conclusion

With the increased use of corporate-owned life insurance, life insurance share planning can resolve distribution problems in the context of family business succession. The use of life insurance shares may be tailored to the particular circumstances. However, care should be taken to fully contemplate the tax and non-tax issues associated with the issuance of these shares. ●



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Florence Marino is the Head of Tax, Retirement and Estate Planning Services at Manulife Insurance Canada, and she provides tax, retirement, estate and insurance planning support and consultation to advisors regarding complex cases in the affluent

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