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COMMENT

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Life Insurance Policy Transfers

The reason for buying life insurance is often different than the reason for keeping life insurance. This adage is a constant consideration in insurance planning, particularly when ownership of a life insurance policy needs to change over time as needs evolve.

Some examples of transfers that may occur after a period of time include:

- Spouse to child
- Parent (or grandparent) to child (or grandchild)
- Deceased individual to his or her estate
- Estate to beneficiary
- Shareholder to company
- Company to shareholder or employee
- Company to company
- Individual to a trust
- Trust to a beneficiary
- Donor to a charity

The general rule is that a transfer of ownership is a disposition for income tax purposes and the transferor (i.e., the insured, policyholder or owner) will recognize an income gain (i.e., 100 per cent taxable) to the extent the proceeds of the disposition exceed the adjusted cost basis (ACB) in the policy. It should also be noted that a loss is not recognized for income tax purposes.

However, there are a number of exceptions that could allow an owner to avoid the immediate income tax implications of a disposition.

Subsections 148(8.1) and (8.2) of the Income Tax Act allow a tax-free rollover between spouses during their lifetime, or where the life insured is not the same as the owner, from an estate after death to the surviving spouse. One condition is that both of the spouses must be resident in Canada at the time of transfer. The original owner is deemed to have received proceeds of disposition equal to his or her ACB in the policy and the new owner is deemed to have acquired the policy at the same cost. It should be noted that the spouses can elect out of the rollover treatment, although the advantages of doing so are unclear.

Subsection 148(8) allows a parent a tax-free rollover on an *intervivos* basis (i.e., during the parent's lifetime) from himself or herself to a child, if a child is the life insured under the policy. One condition is that the transfer must be a gift, with no consideration received or paid. For the purposes of this provision, the extended definition of "child" is used, which means that a grandparent could transfer a policy on his or her own child's life to his or her grandchild. It should be noted that the provision will only apply where the child is the only life insured under the policy. Because this provision cannot be used to transfer a policy from the parent's estate to a child, planning could involve naming the child as successor owner of the policy such that the transfer would take place automatically upon death.

Lastly, subsection 148(7) covers transfers by way of a gift or transfers in any other manner to any other person with whom the policyholder is not dealing at arm's length. This provision deems the original owner to have received proceeds of disposition equal to the cash surrender value of the policy and the new owner to have acquired the policy for an equal amount.

While subsection 148(7) defines the deemed proceeds of disposition, it does not override the measurement of an employee or shareholder

benefit that may occur when a corporation transfers a policy on the life of such a person to that person. The shareholder or employee would be deemed to have received a benefit equal to the fair market value of the policy in excess of what he or she actually paid. This is very important because, while an employee benefit would be tax deductible to the company, a shareholder benefit would not be tax deductible. Where the individual who received the policy is both an employee and a shareholder, careful consideration must be given to determine which set of rules applies.

An advantage (or disadvantage) of the deeming rules in subsection 148(7) is that they override the real fair market value of the transaction. If a personally owned life insurance policy is transferred to the individual's corporation for an amount equal to fair market value that may be greater than the policy's cash surrender value, the excess amount of proceeds of disposition is not taxed to the individual nor is it recognized as part of the corporation's ACB.

Where a donor gifts an existing life insurance policy to charity, the Canada Revenue Agency (CRA) permits the charity to issue a receipt equal to the policy's fair market value. In such a situation, under subsection 148(7), the donor would be deemed to have disposed of the policy for proceeds of disposition equal to the cash surrender value of the policy. The donor would be subject to tax only if the cash surrender value exceeded the ACB, even though the charitable receipt could be for a much higher amount.

The fair market value of a life insurance policy is not an easy figure to calculate. The CRA lists the factors that they would consider in determining fair market value as including: the cash surrender value of the policy; the policy's loan value; the face amount of the policy; the health of the life insured and his or her life expectancy; any conversion privileges in the contract; other riders; and the replacement value of the policy.

While the transfer from a personal trust to a beneficiary is not covered in section 148, there is a provision in the Income Tax Act that allows a tax-free rollover. The trust will be deemed to have received proceeds of disposition equal to its cost in the policy and the beneficiary will be deemed to have acquired the life insurance policy for an equal amount.

Over time, life insurance policies may need to be transferred to better fit the changing situation and the income tax consequences will need to be observed in order to avoid an unintended financial consequence.

I/R 7401.00, 8301.00

Freeze Share Valuation

An estate freeze is a common transaction generally designed to "freeze" the value of an asset in the hands of the original owner and allow subsequent growth in that asset to accrue to new owners. Most commonly, an estate freeze involves shares of a family business, where the first generation of owners wishes to crystallize their value at a point in time and pass future growth in the business to the next generation.

One of the critical factors in completing an estate freeze is to ensure that the fair market value of the property transferred into the freeze structure is equal to the fair market value of the consideration taken back. This means that if common shares are being transferred into a holding company, the holding company must issue fixed-value preferred shares of equal value in exchange. The same considerations apply where common shares are exchanged for preferred shares of the same company rather than being transferred to a holding company.

In order to establish value, the preferred shares usually carry a redemption/retraction feature so that the holder is in a theoretical position of being able to convert the fixed-value preferred shares into cash.

Beyond the tax strategy of completing an estate freeze, additional attributes may be attached to the preferred shares in order to provide the shareholder with various features:

- the shares may be dividend bearing so that the shareholder has a right to a return on the equity in the company represented by the fixed-value preferred shares;
- the shares may provide for cumulative dividends so that the shareholder's entitlement would accumulate if dividends were not paid in a given period;
- the shares can be voting so that the shareholder will be able to protect his or her equity in the

business by having a voice at shareholder meetings;

- the shares could be convertible to common shares so that the shareholder has an opportunity to re-enter the growth opportunity of the company.

The Canada Revenue Agency (CRA) looks at the value assigned to the fixed-value preferred shares from an income tax perspective. If the value of the preferred shares is higher than that of the common shares transferred into the holding company, the freezer will incur a taxable benefit. If the value of the fixed-value preferred shares is lower than that of the common shares transferred into the holding company, double taxation will arise.

One area of concern that has arisen over the years is whether the presence of votes on the preferred shares influences their value. The votes on the preferred shares would typically be structured in such a fashion that the fixed-value preferred shares could control the company. Should a premium be added to the value of the preferred shares to take into account their ability to control the corporation?

This question was recently put to the CRA at a Canadian Tax Foundation meeting in British Columbia. The CRA's response was to reiterate that it does not have a published position on this issue and that valuation would be fact-dependent. The CRA would value the entire company and then allocate the overall value of the company to the various classes of shares outstanding.

While a block of voting shares may carry a premium for the control it offers, the CRA has indicated that in private company situations where the voting control is necessary to protect a freezing shareholder's equity in the company, generally there is no premium added to fixed-value preferred shares for purposes of the deemed disposition upon death rules in the Income Tax Act.

I/R 8301.00, 2500.05

The Strategy of An Estate Plan

Estate planning is more art than science. The science is the ability to create a strategy that takes into account all of the facts of the situation, meets all of the requirements of the Income Tax Act and accomplishes most, if not all, of the individual's objectives. The art is the ability to create a strategy that is flexible enough to take into account all of the possible future events that could befall the individual.

A practical rule of thumb is to keep an estate plan as simple as possible. First, the complexity of a plan is limited by the individual's ability to understand and authorize implementation. Second, the more complex the plan, the more complex the annual maintenance required to ensure the intended benefits are achieved. If the individual must maintain a set of annual transactions or monitor performance, the longevity of the plan may be at risk. Lastly, plans based on a sophisticated technical point may become unstable over time because of changes in interpretation and subsequent court rulings. A plan that is onside today may fall offside over time if the technical point that the plan was based on becomes less certain. However, if the plan is based on more widely accepted practices and strategies, it is less likely a dramatic change will occur based on interpretation or court decisions.

A plan must be able to withstand changes in the family context. Corporate reorganizations that involve young children will have to withstand each child's future marital situation. While a marriage contract may be the usual answer, it is often not an easy task to implement. Once the children are married, the plan needs to consider the implications of divorce and whether the shares of the family business may be subject to claim or division.

Apart from marital situations, the children may actually start their own business(es) and be successful on their own. A plan established today may frustrate the tax planning those children undertake as business owners. One example is the small business deduction that groups associated companies together. A beneficiary of a discretionary trust is deemed to own all of the shares when applying these rules, which could mean that the companies are associated and the small business deduction must be shared.

Another possibility is the future location of the children. It is becoming more common that children move abroad, whether it is with their spouses, to explore a career or to start a business. The issue is that the tax-free rollout of trust property is not available for non-resident beneficiaries. This means that the trust may be forced through a deemed disposition on its 21st anniversary.

The typical successful business person will enter into an estate plan only if he or she can continue to control the business, its direction, its finances, its operations and other critical aspects. However, an estate freeze will introduce other shareholders such as the spouse, children directly or children indirectly through a trust. As new shareholders are introduced, the successful business person now takes on additional responsibilities and is required to be fair to all parties. No longer can the successful business person make decisions completely independently; he or she must consider the positions of the other shareholders. As long as there is family harmony the situation will tend to operate fairly smoothly, but a disgruntled family member (or spouse of a disgruntled family member) who is also a shareholder (directly or indirectly) has certain rights that can be exercised. The successful business person may find that he or she cannot exercise the family trust's discretionary powers of distribution. The children may exercise minority shareholder rights to seek value for their financial position.

Estate planning is far more art than science. The planning must take into account the facts of the situation as well as what the individual wants or thinks he or she wants. Ultimately, the plan must make sense in the long term as circumstances evolve.

I/R 2500.00

Prescribed Interest Rates

The Canada Revenue Agency has released the prescribed interest rate for the fourth quarter of 2009.

- One per cent per annum is the basic prescribed rate for the fourth quarter of 2009. This rate will be used to calculate the deemed interest benefit on subsidized employee loans, loans between non-arm's-length individuals, corporate attribution, shareholder benefits, etc.
- The basic prescribed rate of one per cent plus an additional fixed two per cent (i.e., three per cent in total) is used to calculate the interest owing by the federal government to the taxpayer on income tax overpayments.
- The basic prescribed rate of one per cent plus an additional fixed four per cent (i.e., five per cent in total) is used to calculate interest owing by a taxpayer to the federal government on overdue income taxes, insufficient income tax instalments, unremitted source deductions and unpaid penalties.

I/R 7300.00

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