canada life

Cash surrender value impact on share value at death

On death, there's concern over how a corporate-owned life insurance policy may affect the value of the deceased's private company shares for tax purposes. However, there are situations where a policy's cash value may not impact the valuation of the shares for tax purposes, or at least, the impact is less than anticipated.

The *Income Tax Act* (Canada) (the "Act") deems most capital property owned by an individual to be disposed of on death at its fair market value (FMV)[i]. This could result in capital gains, depending on the adjusted cost base (ACB) of the properties. Determining a property's FMV can be difficult, especially if the property is shares of a private corporation. The Canada Revenue Agency (CRA) outlines their general valuation principles, practices, and policies in Information Circular 89-3, in respect of the valuation of securities and intangible property of closely-held corporations. Considerations in valuing shares of a closely-held corporation include balance sheet, earnings records, existence of goodwill, and the value of corporate assets.

A life insurance policy is an asset of a corporation. In specific circumstances, when a shareholder dies, the Act permits the use of the corporate-owned life insurance policy's cash surrender value (CSV) instead of its FMV in determining the value of the deceased's shares. The CSV can only be used in share valuations for a corporate-owned policy on the life of the deceased or an individual that is not at arm's length with the deceased[ii]. When corporate-owned life insurance policies are used as part of a buy-sell arrangement between arm's length individuals, the FMV of the policies must be used in determining the FMV of the shares.

Cash surrender value does not impact the value of shares

Situations where the value of corporate shares may not be impacted by the CSV of a corporate-owned life insurance policy include:

- **Spousal rollover:** If the shares are left to a spouse, common-law partner (or qualifying spousal or common-law trust), a tax-deferred rollover is available[iii]. Shares automatically transfer to the spouse at their ACB, regardless of the CSV of the corporate-owned life insurance policy.
- **Estate freeze:** If an estate freeze has been implemented where the deceased owns fixed-value preferred shares, the CSV of the corporate-owned life insurance policy won't impact the value of those shares. The shares' FMV would be limited to their fixed redemption value.
- **Collateral loan:** When a corporate-owned life insurance policy is used as collateral for a third-party loan, the policy's CSV may not impact the value of the shares. If the loan is to the corporation, general valuation principles will fully, or partially, offset the effect of the policy's CSV on the value of the deceased's shares for tax purposes.
- Life insurance shares: If life insurance shares are issued to children or a family trust, on the death of the common shareholder, the CSV of the life insurance policy would not be included in valuing the common shares, as that amount would be reflected in the life insurance shares[iv].

Post-mortem planning

If one of the above situations isn't available, post-mortem planning may minimize the impact of the life insurance policy's CSV on the value of the deceased's shares for tax purposes, if properly implemented[v]. That impact depends on the value of the corporation's other assets at the time of the shareholder's death. Generally, if that value is equal to or greater than the policy's CSV at time of death and loss carry-back planning is implemented, the CSV won't have an impact on the deceased estate's[vi] tax liability.

The following three examples show how a life insurance policy's CSV impacts the FMV of a deceased's shares with a corporation owning varying amounts of non-insurance assets. Assume the following for each example:

- The deceased owns all the shares of the corporation, with a nominal ACB and paid-up capital ("PUC").

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- The deceased doesn't have a spouse who would receive the shares at death
- The corporation owns a life insurance policy on the life of the deceased with a CSV of $1 million, a death benefit of $2 million and an ACB of zero.

Example A: Corporation has non-insurance assets of $1 million cash (or tax-paid assets)

Upon the death of the insured:

- Deemed disposition of their shares for $2 million (cash of $1 million plus the policy's $1 million CSV).
- A capital gain of $2 million is reported in the deceased's final tax return, since the shares have a nominal ACB.
- The deceased's estate now owns shares with an ACB of $2 million.
- The corporation:
  - Receives the death benefit and an increase to its capital dividend account (CDA) of $2 million[vii]
  - Has assets worth $3 million (insurance proceeds of $2 million plus cash of $1 million)
  - Is wound-up through a redemption of shares resulting in a $3 million distribution to the estate
- The share redemption provides the following tax consequences[viii] to the estate:
  - Tax-free capital dividend of $2 million
  - Taxable dividend of $1 million[ix]
  - Capital loss of $2 million

The stop-loss rules[x] don't impact the estate's ability to carry the capital loss back to the deceased's final tax return, since the estate received a taxable dividend of $1 million[xi]. The capital loss that's carried back will fully offset the capital gain that arose on the insured's death[xii].

Consequently, only $1 million of the original cash in the corporation will be taxable to the estate, with no taxable impact from the policy's CSV. In situations where the corporation's assets are greater than the CSV of the life insurance policy, similar tax results are achieved. The value of the cash would be treated as a taxable dividend with no taxable impact from the CSV of the policy.

Example B: Corporation has non-insurance assets of $500,000 cash (or tax-paid assets)

Upon the death of the insured:

- Deemed disposition of their shares for $1.5 million (cash of $500,000 plus the policy's $1 million CSV).
- A capital gain of $1.5 million is reported in the deceased's final tax return.
- The estate now owns the shares with an ACB of $1.5 million.
- The corporation:
  - Receives the death benefit and increase to its CDA of $2 million
  - Has assets worth $2.5 million (insurance proceeds of $2 million plus cash of $500,000)
  - Is wound-up through a redemption of shares resulting in a $2.5 million distribution to the estate
- The share redemption provides the following tax consequences to the estate:
  - Tax-free capital dividend of $2 million
  - Taxable dividend of $500,000
  - Capital loss of $1.5 million

The wind-up initially results in a $1.5 million capital loss for the estate; however, the stop-loss rules reduce the capital loss by $250,000 so the estate now has a capital loss of $1.25 million. The estate can then carry this capital loss back to the deceased's final tax return. The capital loss will partially offset the taxable capital gain that arose on death, leaving a capital gain in the final return of $250,000.

Accordingly, only $500,000 of the original cash in the corporation is taxable to the estate as a dividend, and a $250,000 capital gain remains in the deceased's final tax return. Where the life insurance policy's CSV is greater than one-half of the value of the corporation's non-insurance assets, the stop-loss rules reduce the amount of the capital loss incurred in the estate and thus, carried back to the final tax return.

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Example C: Corporation doesn’t have non-insurance assets (or tax-paid assets)

Upon the death of the insured:

- Deemed disposition of their shares for $1 million (the $1 million CSV).
- A capital gain of $1 million is reported in the deceased’s final tax return.
- The deceased’s estate now owns shares with an ACB of $1 million.
- The corporation:
    - Receives the death benefit and an increase to its CDA of $2 million
    - Has assets worth $2 million (insurance proceeds of $2 million)
    - Is wound-up through a redemption of shares resulting in a $2 million distribution to the estate
- The share redemption provides the following tax consequences to the estate:
    - Tax-free capital dividend of $2 million
    - Taxable dividend $0
    - Capital loss of $1 million

This wind-up initially results in a $1 million capital loss for the estate; however, the stop-loss rules reduce the capital loss by $500,000 so the estate now has a capital loss of $500,000. The estate can then carry this capital loss back to the deceased’s final tax return. The capital loss will partially offset the taxable capital gain that arose on death, leaving a capital gain in the terminal return of $500,000.

As a result, effectively only 50% of the policy’s CSV will be taxed as a capital gain when the life insurance policy is the only asset of the company.

Summary of examples

Insurance death benefit	$2,000,000	$2,000,000	$2,000,000
Policy CSV	$1,000,000	$1,000,000	$1,000,000
Non-insurance assets	$1,000,000	$500,000	0
Share value at death / capital gain	$2,000,000	$1,500,000	$1,000,000
Assets distributed on wind-up	$3,000,000	$2,500,000	$2,000,000
Taxable dividend	$1,000,000	$500,000	0
Tax-free capital dividend	$2,000,000	$2,000,000	$2,000,000
Capital loss available to carry back	$2,000,000	$1,250,000	$500,000
Capital gain on final return	0	$250,000	$500,000

The above examples are for illustrative purposes only. Situations will vary according to specific circumstances.

Conclusion

A corporate-owned life insurance policy’s CSV doesn’t always impact the value of the deceased’s shares for tax purposes because of certain planning measures like spousal rollovers and estate freezes. Where these measures aren’t available and loss carry-back planning is implemented, the estate’s tax liability is only impacted when the policy’s CSV exceeds the value of the corporation’s non-insurance assets at time of death. In those cases, the rule of thumb is that the amount subject to capital gains taxation is only 50% of the amount that the CSV exceeds the corporation’s non-insurance assets at time of death.

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[i] Subsection 70(5) of the Act.

[ii] Subsection 70(5.3) of the Act.

[iii] Subsection 70(6) of the Act.

[iv] Generally, life insurance shares: are non-voting, entitle the holder to dividends equal to the life insurance proceeds on death of the common shareholder, are redeemable by the holder prior to the common shareholder's death, for an amount equal to the CSV of the policy, and entitle the holder to an amount equal to the policy's CSV on the winding up of the corporation.

[v] In this article, we are using loss carry back planning. The tax results may be different if pipeline planning is used instead.

[vi] All references to estate in this document refer to an estate eligible as a graduated rate estate of the deceased.

[vii] Inclusion to CDA is the insurance proceeds of $2 million less ACB of $0.

[viii] Subsection 84(2) of the Act.

[ix] Deemed dividend less the capital dividend.

[x] The stop-loss rules are complicated, but basically if more than half of the deemed dividend to the estate is a tax-free capital dividend then the estate is restricted from carrying back all or part of its loss.

[xi] Subsection 112(3.2) of the Act.

[xii] Subsection 164(6) of the Act.