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Golini v. The Queen: Tax Court case and shareholder borrowing

In the context of leveraging with life insurance, the term shareholder borrowing refers to a collateral loan that's received by a shareholder and secured by a corporate-owned life insurance policy. It's a strategy with many tax considerations[i], one of which is the potential taxable benefit a shareholder receives from obtaining a loan that's secured by the corporate-owned policy. A 2016 case from the Tax Court of Canada addresses this issue with unfavourable results for the taxpayer, but its facts are so unique, it's unclear if it will have a broader application.

Law students learn that bad facts make bad law. *Golini v. The Queen* (2016) TCC 174 ("*Golini*") reinforces this lesson.

The case involves offshore products, offshore insurers and lenders, a limited recourse loan and money moving in a circle to create immediate tax benefits. The life insurance policy involved in the case wasn't used to address the shareholder's estate planning needs.

The following is a summary of what happened in *Golini*:

1. The taxpayer is Paul Golini (Paul). He owned shares in his operating company (Opco) worth $6 million. These shares had a nominal paid-up capital (PUC), meaning if he were to redeem the shares, almost the entire $6 million would be deemed a taxable dividend to him.

2. He incorporated a holding company (Holdco) and exchanged the shares of Opco with the shares of Holdco. Opco received a $6 million loan from an offshore bank (the Bank) and used the proceeds to redeem the shares owned by Holdco.

3. Holdco purchased an annuity from an offshore insurer using the redemption proceeds of $6 million. The annuity paid out $400,000 annually to the earliest of 15 years or Paul's death. Holdco also purchased a life insurance policy on Paul's life from another offshore insurer having $6 million of initial coverage (the death benefit increases, as noted in point 6) and an annual premium of $400,000 payable for 15 years. The annuity payout paid the insurance premium.

4. The offshore insurers reinsured the life insurance and annuity with an offshore reinsurer for a cost of $6 million (i.e., the $6 million paid by Holdco to buy the annuity was transferred to reinsurer). The reinsurer lent $6 million with interest to another offshore company, which in turn lent $6 million with interest to a Canadian company (Canco).

5. Canco is unrelated to Paul. Canco lent $6 million to Paul. The loan was guaranteed by Holdco and secured by its annuity and life insurance policy. The loan was also a limited recourse loan. This was a key fact for the judge in this case.

6. Paul paid an annual guarantee fee of $40,000 to Holdco. He was to pay this amount for 15 years. Paul also paid part of the interest on the Canco loan and the unpaid interest was capitalized. The death benefit grew in-step with the growing loan balance.

7. Paul used the $6 million loan proceeds to subscribe for a specific class of shares in Opco, giving them a high PUC. PUC enables a shareholder to withdraw funds from a corporation, tax free.

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8. Opco used the $6 million share subscription proceeds to repay the Bank.

9. The result was:

    - The creation of an interest expense Paul may deduct against other income

    - The increase in PUC of shares Paul owned in Opco to $6 million, which can now be withdrawn tax free, instead of taxable-deemed dividend

Based on Paul's immediate access to $6 million and the non-recourse loan, the Tax Court found Paul received a shareholder benefit in the amount of $5.4 million – calculated as the total insurance premiums ($6 million) less the total paid and planned guarantee fee payments ($600,000). This method of calculating the shareholder benefit is unusual as it focuses on the policy's cumulative premium amounts less the cumulative guarantee fee payments, rather than either the total loan amount received by Paul or what an acceptable guarantee fee might have been. Focusing on the cost of the product assigned as security may make sense in the context of the judgement since the Tax Court found the shareholder benefit to arise because Paul was off the hook – in both form and substance – from repaying the Canco loan. This occurred pursuant to the assignment of the annuity and the insurance policy. However, if it turns out that *Golini* has a broader application, it's difficult to imagine how calculating a shareholder benefit this way applies in a traditional back-end leveraging case where a shareholder receives a smaller loan amount over several years.

Other issues considered by the Tax Court were the deductibility of the interest payments, sham and the general anti-avoidance rule.

How advisors dealt with shareholder borrowing pre-*Golini*

Generally, the Canada Revenue Agency (CRA) has said the determination of whether a corporation has conferred a taxable shareholder benefit in the context of shareholder borrowing is a question of fact and has no firm guidelines as to when it will assess a benefit[ii]. However, the CRA gave some guidance by indicating it wouldn't consider the shareholder receiving a taxable benefit from the corporation where he or she pays the corporate policyowner a "reasonable fee" as consideration for using its asset as security for the personal loan or for guaranteeing the loan[iii].

As a result, the current industry practice is for the shareholder who receives the loan to pay an annual guarantee fee to the corporation for use of its life insurance policy as security. The CRA gave no guidance on how to determine a reasonable fee, but the insurance industry has generally recommended the annual guarantee fee be within a range of 1.0 – 2% of the total outstanding loan[iv]. Our corporate asset efficiency strategy illustration allows the user to input a guarantee fee where loan to shareholder is selected as the distribution option.

How will advisors deal with shareholder borrowing post-*Golini*?

It's unclear if *Golini* as a standalone case invalidates the CRA's guidance outlined above with respect to paying a guarantee fee[v]. The reason for the uncertainty is the Tax Court's findings that, given the circumstances, the taxpayer received a loan he wasn't required to repay. This is a unique situation that probably wouldn't occur if domestic insurers and lenders were involved.

The Tax Court stated, "the reality, supported by the documents and the context of the overall plan, is that [the shareholder] would not have to repay the loan."[vi]

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Two key facts support this statement:

1. The loan from Canco to Paul was a limited recourse loan, meaning if Paul defaulted on the loan, Canco's only recourse against both him and Holdco was the insurance policy and annuity.
2. The judge found "[e]veryone's understanding was the annuity and the insurance were the only manner" in which the Canco loan would be repaid and that "the documents do not contradict that understanding."[vii]

It's unlikely this would have occurred if a domestic arm's-length bank was the lender, because normally both Paul and Holdco would have been required to repay a full recourse loan as borrower or guarantor. There are several other ways in which the *Golini* facts are different from a shareholder borrowing case if, for example, a Canada Life™ permanent life insurance cash value policy is used as security for a loan from a domestic arm's-length bank:

- Most importantly, as noted, the loan to the shareholder would not be a "virtually risk-free" limited recourse loan as was the case in *Golini*[viii]. The shareholder would be responsible for the loan's repayment. His or her personal assets could be exposed in the event of defaulting on the loan, even though the corporate-owned life insurance policy is collaterally assigned as security.

- There would be a commercial reality to both the insurance policy and the loan, which appears to be missing in many respects in *Golini*. Notably:

  - The policy's values wouldn't be linked to the growth of the loan. In *Golini* the growth of the insurance policy's death benefit mirrored the growth of the outstanding loan.

  - The loan would be secured by the cash value of the policy rather than the death benefit, as it was in *Golini*.

  - The insurance policy would be a real insurance product.

- While a loan from a domestic lender could move circularly to create tax benefits for the shareholder (seen in *Golini* with the creation of PUC), our corporate asset efficiency strategy illustration does not permit the user to illustrate this type of transaction.

- In back-end leveraging situations involving shareholder borrowing, the acquisition of the life insurance policy and the collateral loan are done many years apart. In *Golini*, the acquisition of the life insurance policy and the loan were done simultaneously.

Despite the differences the facts in *Golini* have with a more traditional shareholder borrowing situation, clients should still be made aware of the potential application of this case where shareholder borrowing is either contemplated or undertaken. This includes making clients aware that paying a guarantee fee may not prevent the CRA or a court from finding a shareholder benefit, and if there is a benefit, there is uncertainty as to how it's calculated. The Tax Court's decision in *Golini* was initially appealed to the Federal Court of Appeal but was later withdrawn.

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[i] These considerations are covered in the Tax and Planning article titled, "Backend leveraging: loan to shareholder v. loan to corporation.

[ii] See CRA Technical Interpretation, 2006-0174011C6.

[iii] See CRA Technical Interpretation, 2006-0174011C6.

[iv] In some cases, guarantee fees may be lower than this range. For example, see Stephens, Glenn, *Estate Planning with Life Insurance* 7th ed. Toronto: Wolters Kluwer, 2019 at p 271 where the author indicates that suggested guarantee fees are "usually in the range of 0.5% of the outstanding loan" and that, however, "clients should determine what the prevailing acceptable rates are at the time the loan is negotiated."

[v] At the time of writing this article, the CRA's comments on this case have been limited to expressing its ongoing concern with "with planning arrangements similar to those undertaken in the *Golini* case" and that "the CRA will continue to take action to detect and to address domestic and cross-border tax planning schemes with life insurance products which seek to achieve preferential tax benefits contrary to the underlying tax policy". See Question 7 at the CRA/CALU roundtable, CRA document 2018-0752971C6.

[vi] *Golini*, para 96.

[vii] *Golini*, para 97.

[viii] *Golini*, para 84.

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