Life insurance shares

Life insurance shares are a planning tool for clients who have or are considering corporate-owned life insurance policies. The shares may be used to stream insurance proceeds from the corporate policy beneficiary to the holder of the life insurance shares. Life insurance shares may also act as a preference share that tracks the corporate-owned policy's cash value. This effectively removes this value from the estate of the deceased shareholder. This article discusses how life insurance shares may be used in a client's estate planning and how to set them up.

Life insurance shares main purposes

Limiting the value of the deceased shareholder's estate

When a business owner dies, they're deemed to dispose of their capital property, including their shares, at fair market value (FMV) for tax purposes. The cash surrender value (CSV) of their corporation's life insurance policy on their life is included in calculating the FMV of their shares.[i] This may increase the shareholder's tax liability at death. Life insurance shares may be used to attribute this value associated with the policy's CSV from the common shareholder's estate and into the hands of the holder of the life insurance shares[ii]. The life insurance shares may achieve this result by having a redemption value that tracks the CSV of the life insurance policy owned by the corporation. This type of life insurance share is referred to as a "CSV tracking life insurance share".

The preferential redemption amount of the CSV tracking life insurance shares rank ahead of the common shareholders in the event of company dissolution. As a result, the policies' CSV is reflected in the life insurance shares value and not the common shares value. In these cases, the life insurance shares holder is typically either a family member or a family trust.

Ensuring the right person benefits from the insurance money

The business owner may want the insurance money to ultimately end up in the hands of someone who won't be a shareholder of the corporate policyowner.[iii] This may be a problem because corporate policyowners are virtually always the beneficiaries of their life insurance policies and insurance money paid from corporations are typically distributed by dividends paid to shareholders. This is the other main purpose of life insurance shares, using them to ensure that a person who otherwise wouldn't be a shareholder ultimately receives the insurance money via dividend(s) paid on the life insurance shares. This type of life insurance share without the CSV tracking feature are referred to as "streaming life insurance shares". CSV tracking life insurance shares may also serve this streaming function as well.

Consider a situation where the business owner has children from another marriage (to whom they would like to leave a legacy using life insurance). They may also wish to defer capital gains taxes at death by transferring their shares to their current spouse. If the children from the first marriage aren't shareholders, how can they receive the insurance money as a capital/taxable dividend? In these circumstances, having the children of the first marriage own streaming life insurance shares is one way to help ensure they receive the life insurance proceeds.[iv]

Uses of life insurance shares

Possible uses of CSV tracking or streaming life insurance shares include:

- Limiting estate value for tax purposes (estate planning)
- Estate equalization
- Matrimonial concerns
- Shareholder exit strategies and buy/sell agreements
- Key person strategies

Characteristics of life insurance shares

As noted, life insurance shares can be structured in different ways which means the rights attached to them can vary. For example, streaming life insurance shares may be simple non-voting, non-participating, discretionary dividend shares and their holder has no redemption and dividend entitlements until after the death of the life insured. The entitlement to an amount relating to the death benefit may be established pursuant to either the share terms in the corporation's articles or a shareholders' agreement. Alternatively, CSV tracking life insurance shares typically has the following rights set out in the share terms: non-voting, non-participating and a specific redemption and dividend entitlements that relate to the CSV and/or death benefit of a life insurance policy owned by the issuing corporation.

CSV tracking life insurance shares are likely the most common type of life insurance share that are raised in planning discussions. This kind of share was described in Question 11 at the 2005 APFF Conference's Canada Revenue Agency (CRA) Roundtable[v]. Here, the life insurance share was generally designed to have a redemption value that tracks the policy's CSV during the life insured's life and then the death benefit at death. In particular, the CRA considered the situation involving a corporate-owned life insurance policy where the life insured owns all the common shares of the company. Prior to the corporation purchasing a life insurance policy on the shareholder's life, the life insured's adult child acquires life insurance shares from the corporation for $1 and has the following characteristics:

- Non-voting
- No dividend entitlement other than a dividend of an amount equal to the policy's death benefit after the death of the life insured
- Prior to the death of the life insured, redeemable at the holder's option for an amount equal to the policy's CSV. This amount isn't payable until after the corporation receives the policy's death benefit. The holder may be entitled to this amount upon liquidation of the company.

- After the death of the life insured, the shares are redeemable at the holder's option for an amount equal to the policy's death benefit, less dividends paid to date. Again, this amount wouldn't be payable until after the corporation receives the death benefit. The holder would also be entitled to this amount upon liquidation of the company.
- The shares are redeemable at the corporation's option at any time after the taxpayer's death. This is 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. Any payments for the redemption amount are deferred until the corporation receives the policy's death benefit.

The CRA stated that it wouldn't be unreasonable to allocate the amount of the policy's CSV immediately before death to the insurance shares and not the value of the common shares held by the life insured. This favorable position was reconfirmed by the CRA in Question 4 at the 2021 CLHIA Conference CRA roundtable. However, the CRA emphasized that its comments on the life insurance shares' efficacy, reflecting the value of the policy's CSV, shouldn't be construed as a fulsome consideration of the tax issues which could arise when using life insurance shares. Some of these tax issues are discussed below.

Considerations

Considerations for the life insurance shares holder

- **Valuation**: For tax purposes, the life insurance shares holder should pay FMV consideration to the corporation for their issuance. If the holder pays *less* than FMV consideration for the shares at issuance, then there's a risk that the holder could be considered to have received a taxable benefit from the corporation.[vi] This would result in an income inclusion to the holder of an amount equal to the FMV of the life insurance shares less the amount paid.

- **Death**: The life insurance shares holder should address in their Will what happens to the shares at death, which would be a concern if the holder predeceases the life insured. This issue could also be dealt with in a shareholders' agreement. Also, if CSV tracking life insurance shares are used then they have value while the life insured is alive and the holder, as a result, has a potential tax liability at death issue to consider.

- **Family law**: If the life insurance shares holder has a spouse (or plans to have a spouse), then consideration should be given to how they'll be treated upon a breakdown of marriage. Using a family trust to own the shares or having the life insured (parent) acquire them at issuance and then gifted to the holder are two strategies for having the shares not be included in a net family property calculation. Clients should consult a legal professional for advice on these issues.

- **Tax on split income**: The client's tax advisors may also consider whether the tax on split income (TOSI) applies to any taxable dividends paid on the life insurance shares.

Considerations for the common shareholder

- **Valuation**: The tax risks to the common shareholder also concern whether the life insurance shares holder pays FMV consideration to the corporation for their issuance. The risk is that if the common shareholder authorizes the issuance of the life insurance shares to a non-arm's length person for an amount *less* than FMV, then the CRA may argue that the controlling shareholder is disposing of an interest in their common shares to the life insurance shares holder. Although there's no disposition of the shares, the CRA would consider the depleted value of the common shares to result in a taxable disposition, potentially resulting in a capital gain. The CRA has considered taxable dispositions that occur in similar situations.[vii]

- **Life insurance shareholder conduct**: Failure to plan for circumstances like death, marriage breakdown or bankruptcy of the life insurance shareholder may be catastrophic for the common shareholder and their estate planning. These risks can be addressed through trusts (death and marriage breakdown) or shareholders' agreement (bankruptcy). Moreover, the life insurance shares holder, even where the shares are non-voting, may impede certain corporate actions, like a sale of the business or a corporate reorganization. The holder also has access to the statutory oppression remedy which is available if the corporation is unfairly prejudicial or unfairly disregards to the interests as shareholder.[viii]

Comment on the value of life insurance shares at issuance

Since addressing the main tax risks associated with life insurance shares stems from whether FMV consideration is paid for their issuance, it's recommended that clients retain a valuator for this purpose. Several factors could have a role in determining the value of life insurance shares at the time of issuance. For example, the FMV of CSV tracking life insurance shares issued by a corporation, that has enough cash and investments to pay the total amount of premiums for a high CSV life insurance policy, would seemingly be higher in comparison to where the shares were issued by a corporation that needs to fund the premiums using future cash flows. In the case of the former, there's significantly less risk that the FMV of the life insurance shares won't increase as projected since funding for future premiums is already secured.

Tax risks to the corporate policyowner

In the event the life insurance shares are considered "taxable preferred shares" under the ITA, the corporation's tax advisors may also consider whether it's subject to Part VI.1 tax in respect of any taxable dividends paid on the shares.

Setting up life insurance shares

Regardless of what the life insurance shares characteristics are, setting up this share structure is generally done in the same way. The corporate policyowner will reorganize its share capital so that it has a share class that are the life insurance shares. This share class will give the holder certain rights, as discussed above, that are attributable to a life insurance policy identified in the share terms by carrier and policy number - which may be ascertained before the policy is issued to the corporation. The intended life insurance shares holder subscribes for the shares for FMV which will depend on the circumstances and it's recommended this amount be determined with the assistance of a qualified valuator. After the shares are issued, the corporation then purchases the life insurance policy.

Alternatively, life insurance shares may be set up after the policy is issued to the corporation. In this situation, the FMV of the life insurance shares would be based on the circumstances of the corporate policyowner, the FMV of the life insurance policy and other factors, including the life insured's health status.

[i] Subsection 70(5.3) of the *Income Tax Act* (Canada) (the "ITA").
[ii] Situations where this isnot a concern are where life insured / shareholder has done an estate freeze or where their shares are to be transferred to a spouse (or spousal trust) on a rollover basis.
[iii] The corporate policyowner is almost always the policy beneficiary as well to address any shareholder benefit issues.
[iv] The anti-avoidance provision that applies to streaming capital dividends doesn't apply where the source of capital dividend is life insurance proceeds: ssubs. 83(2.1) and (2.3).
[v] CRA TI 2005-0138111C6, dated October 7, 2005
[vi] Pursuant to subsections 15(1) or 246(1) of the ITA. See CRA TI 2010-0364131E5, dated May 19, 2010.
[vii] Pursuant to paragraph 69(1)(b) of the ITA. See CRA TI 2010-0364131E5, dated May 19, 2010. Also, this is similar to what happened in the case of *Kieboom* v. *The Queen* 1992 DTC 6382 (FCA) where the Federal Court of Appeal held that a taxable benefit was conferred by the taxpayer on his spouse and children as a result of the taxpayer's corporation issuing valuable common shares of the corporation to the spouse and children for nominal consideration – resulting in the taxpayer's common shares decreasing in value. The court held that former paragraph 245(2)(c) of the ITA characterized the benefit as a deemed disposition by way of gift. Regarding the case, the CRA in TI 9228560, dated December 3, 1992, stated, "[i]n our view, following the repeal of paragraph 245(2)(c), a taxpayer who causes a corporation to confer a benefit on a spouse and children in the way described in the *Kieboom* case will be deemed by subparagraph 69(1)(b)(i) to receive proceeds of disposition of property disposed of."
[viii] In Ontario, the oppression remedy is provided for in s. 248 of the *Business Corporations Act* (Ontario). Consider its application if CSV tracking life insurance shares are used and the corporate policyowner wants to surrender the policy.