Backend leveraging: loan to shareholder vs. loan to corporation

What's an effective way to take a bank loan secured by the cash value of a corporate-owned life insurance policy – directly to the shareholder, or to the corporation and then paid out as a dividend?

Leveraging is a way of showing a shareholder how to access the cash value of a corporate-owned life insurance policy. Obviously, a bank loan made directly to the shareholder will provide more after-tax cash to the shareholder since the loan proceeds are received tax-free, compared to corporate borrowing where the loan proceeds are paid to the shareholder via a taxable dividend.

There are, however, several other tax issues to consider, which may lead to the conclusion that corporate borrowing can be more advantageous. This article discusses these tax considerations in hopes of showing the significant differences – from a taxation perspective – between shareholder and corporate borrowing in the context of the corporate collateral loan strategy. There are financial risks associated with leveraging and clients should not purchase life insurance only for the future possibility of obtaining a collateral loan.

Back-to-back loan rules

Rules in the federal *Income Tax Act* (the "Act") applicable to loans outstanding on March 21, 2016 and all future loans may have adverse tax implications for the shareholder borrowing strategy. These rules are the so-called "back-to-back loan" rules. Despite their name, the new rules have nothing to do with the "back-to-back" insurance strategy that's also known as an insured annuity.[1]

Based on the new rules, if a corporate policyowner guarantees a bank loan obtained by one of its shareholders and pledges its life insurance policy (or any property) as security, the loan can be deemed to be a loan made directly from the corporation to the individual shareholder – which may lead to an income inclusion for the individual shareholder in the year for the *full amount* of the loan.[2]

This tax result is dependent on the bank's lending documents. Specifically, there would be an income inclusion under the new rules if the loan documents create a "specified right", as defined in the Act.[3] A specified right could arise if the assignment is worded in such a way that it covers both the current loan and any future loans to the shareholder, or includes any current or future loans to the corporation – which is standard language in most security agreements. Similarly, the ability of the lender to raise funds in any way from the asset provided as security and use the funds for any purpose, other than to reduce the shareholder's loan balance, would also create a specified right.

At the time of writing, some banks that offer collateral loans have loan documentation that creates a specified right under the new rules and are exploring potential solutions. Clients should engage their professional tax advisor to determine whether a specified right would arise from the lender's loan documents prior to starting a shareholder loan program secured by a corporate-owned life insurance policy.

Guarantee fees

With shareholder borrowing, the individual shareholder is receiving a loan secured by a corporate-owned life insurance policy – and in many cases, the corporate policyowner is guaranteeing the loan as well. In these circumstances, the

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[1] Contained in subsections 15(2.16) to (2.192) of the Act.

[2] Pursuant to subsection 15(2) of the Act.

[3] Subsection 18(5) of the Act.

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Canada Revenue Agency (CRA) may consider the shareholder to receive a taxable benefit from the corporation (i.e., for using corporate assets for personal purposes). The CRA's stance on this is as follows:

> Where a shareholder of a corporation borrows money ("Loan") from a financial institution and the corporation guarantees the Loan and/or provides security as collateral to the Loan ("Guarantee") … we will not assess a benefit in the situation where the shareholder is dealing at arm's length with the corporation and there is no evidence that the shareholder is, at the time the Guarantee is granted, unable to repay the Loan … In the situation where the shareholder pays a reasonable fee to the corporation as consideration for the granting of the Guarantee, the Guarantee would not, in and by itself, give rise to a benefit…[4]

The foregoing excerpt explains that the CRA expects the shareholder to pay the corporate policyowner a fee for using its asset as security for a personal loan. Tax professionals typically advise their clients to pay an annual guarantee fee to the corporation in an amount equal to 1.5-2% of the total outstanding loan.

A guarantee fee is passive income to the corporation, which it can pay back to the shareholder as a taxable dividend. In light of the tax consequences of paying a guarantee fee, in some provinces it may be more advantageous to take a shareholder benefit rather than paying a guarantee fee.

A guarantee fee may seem like a small expense in the initial years of implementing the strategy, but it'll increase as the size of the outstanding bank loan increases. As a result, the annual guarantee fee expense may become a significant expense and it continues until death (i.e., even after the "income" stops in a collateral loan illustration). Canada Life's *Corporate asset efficiency* tool has the ability to illustrate a guarantee fee with shareholder borrowing.

Should the CRA consider the shareholder to have received a taxable shareholder benefit, the amount of the benefit may be calculated as an amount equal to a guarantee fee (assuming it wasn't paid by the shareholder) or the difference in interest rates between what the shareholder obtained compared to what he or she would have obtained had the corporation not pledged security.

Uncertainty from case law

The recent court case of *Golini* v. *The Queen*[5] causes some headwinds for the shareholder borrowing strategy as well.

The facts in *Golini* are complicated and are summarized in the *Strategies* article contained in the November 2016 edition of *Newslink*. At a high level, the case involves offshore products, offshore entities, a limited recourse loan and money moving in a circle to create immediate tax benefits. The taxpayer in the case got immediate access to a $6,000,000 non-recourse loan that was secured by his company's insurance policy and annuity. The Tax Court found that the taxpayer received a shareholder benefit in the amount of $5,400,000 – calculated as the total insurance premiums ($6,000,000) less the total paid and planned guarantee fee payments ($600,000). This method of calculating the shareholder benefit is peculiar 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 the taxpayer or what an acceptable guarantee fee might have been. The Tax Court's finding that a shareholder benefit arose seemed to hinge on its finding that the taxpayer was off the hook, in both form and substance, from repaying the loan and this occurred pursuant to his company's assignment of the annuity and the insurance policy.

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[4] CRA Technical Interpretation, 2006- 0174011C6.

[5] (2016) TCC 174 ("*Golini*").

The circumstances in *Golini* differ significantly from a typical shareholder borrowing scenario involving domestic insurance products and a collateral loan lending arrangement with an arm's length bank. The life insurance policy involved in the case also wasn't used to address the shareholder's estate planning needs. Nevertheless, *Golini* causes some concern in relation to the tax implications of shareholder borrowing and whether paying a guarantee fee effectively addresses the shareholder benefit issue discussed above. The case was appealed to the Federal Court of Appeal.

Interest deductibility

Whether the loan is made to either the shareholder or a corporation, for the interest on the loan to be deductible the loan needs to be used by the borrower to earn income from a business or property. In the context of shareholder borrowing, this test wouldn't be met if the loan is used for funding the shareholder's lifestyle in retirement. In contrast, there's an opportunity for obtaining the interest deduction in the context of corporate borrowing even where the loan proceeds will ultimately be used in the hands of the shareholder for retirement funding.

The CRA's administrative position stated in paragraph 50 of their Income Tax Folio S3-F6-C1, titled "Interest Deductibility," states that interest on a loan used to pay a dividend is deductible where the borrowed money replaces the accumulated profits of the corporation that have been retained and used for business or investment purposes. Canada Life's illustration software gives the option of showing interest deductibility, which results in the software applying the tax savings from the interest deduction to service the interest costs of the loan.

Capital gains tax liability at death

At death, individuals are deemed to dispose of their capital property for fair market value (FMV) consideration. For this purpose, when calculating the FMV of a deceased's shares, subsection 70(5.3) of the Act deems the FMV of a corporate-owned life insurance policy on the deceased's life (or the life of a non-arm's person) to equal the policy's cash surrender value (CSV). This rule means that a policy's CSV may impact a shareholder's capital gains tax liability at death. This rule becomes relevant in collateral loan strategies because the insurance policies clients will use have high cash values.

That said, in practice there are often factors that either eliminate or mitigate this perceived added capital gains liability, such as:

1. Where the shareholder implemented an estate freeze
2. The policy is a single life policy on the shareholder's life and his or her shares roll over to a surviving spouse on death
3. Post-mortem planning strategies (see our *Strategies* article in the March 2013 edition of *Newslink*)
4. Using life insurance shares (see our Tax and planning article titled "Life insurance shares")
5. In a collateral loan context, where the loan is paid to the corporation

To elaborate on this last point, the loan to the corporation is a liability of the corporation and, as a result, reduces the FMV of the shares. The loan to the corporation therefore offsets the potential effect of the policy's cash value on the FMV of the deceased's shares for tax purposes. In contrast, a loan to the shareholder does not reduce the value of the shares and thus the cash value of the policy may have a greater impact on the life insured's tax liability at death.

Complexity of loan repayment at death

Under a typical corporate borrowing scenario, the corporation's policy simply repays the bank loan at death. This is very different in the shareholder borrowing context because if the corporate-owned policy pays off the personal debt, there would be a taxable shareholder benefit equal to the amount of the loan. Therefore, on death the bank needs to either accept repayment of the loan from another source of funds or agree to release the policy as security (and additional security be assigned in its place) so that the corporation can receive all of the death benefit and subsequently pay a

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capital dividend to the estate so it can pay off the loan. The borrower and lender should have this issue resolved at the beginning of the lending arrangement.

Excess CDA left over for other non-insurance assets

As noted, with shareholder borrowing the corporation should use its capital dividend account (CDA) credit generated from the life insurance proceeds to pay a capital dividend to the estate so it can pay off the personal loan. With corporate borrowing, the corporation does not need to use its CDA to facilitate the repayment of the loan – it can pay the bank directly. As a result, in many cases there would be excess CDA left over for distributing other non-insurance assets from the corporation as a tax-free capital dividend. This may result in significant tax savings for the shareholder’s heirs. The amount of the excess CDA would be the CDA credit (death benefit less the policy’s adjusted cost basis) less the death benefit left over after the loan is paid off.

Conclusion

Shareholder borrowing in the context of a corporate collateral loan income strategy will provide a shareholder with more after-tax cash in the earlier stages of implementing the strategy. There are, however, tax risks to consider as well, including other factors that’ll impact a shareholder’s cash flow – like guarantee fee payments or not obtaining interest deductibility. Corporate borrowing also has tax advantages at death – like excess CDA, reduced share value for tax purposes and a simple loan repayment process.

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