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Transferring a life insurance policy from a corporation to a shareholder

When a corporation transfers a life insurance policy to a shareholder, there are tax consequences to both the corporation and shareholder. The resulting tax consequences depend on many factors, including whether the shareholder is an individual or a corporation, the tax attributes of the policy, and whether the shareholder paid anything for the policy or if it was transferred as a dividend-in-kind.

Does the policy need to be transferred?

Before transferring the policy, carefully consider whether it actually needs to be transferred. The two most common reasons why someone would want their corporation to transfer out a policy on their life are:

1. The corporation will be sold
2. Its business has stopped, and its only remaining asset is the policy

If significant tax consequences result from transferring the policy, the business owner may consider other options. These could include:

- Selling the corporation's business assets so the corporation's ownership doesn't change
- Transferring the policy as a dividend-in-kind to a connected corporation
- Selling the corporation with the policy but acquiring and retaining life insurance shares
- Keeping the corporation in good standing until the insurance proceeds are paid out (in cases where the business has ceased)

The business owner's professional tax advisor should consider each of these options.

Transferring a policy from a corporation

If the corporate-owned policy needs to be transferred, it's necessary to look at the tax consequences to both the corporate policyowner and shareholder[i].

Tax consequences to the corporation

One of the tax implications for a corporate policyowner (and some of those for the shareholder resulting from transferring a policy to a shareholder are determined by subsection 148(7) of the *Income Tax Act* (the Act). The corporation's transfer price for tax purposes (the proceeds) is deemed to be the greatest of the following:

1. Fair market value (FMV) of the consideration given for the policy
2. Policy's cash surrender value (CSV)
3. Policy's adjusted cost basis (ACB)

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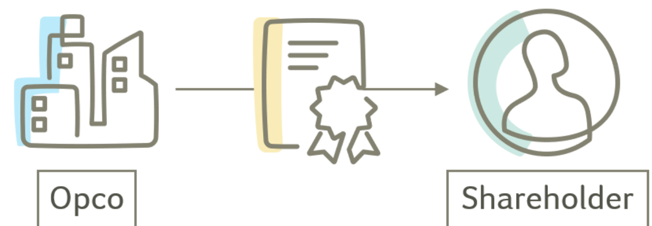
If the deemed proceeds exceed the policy's ACB, then any excess over the ACB is a taxable policy gain and treated as passive income of the corporation. This formula is straightforward, but there are some common situations where its application needs clarification:

- **As a dividend-in-kind** – A corporation transfers the life insurance policy as a dividend to a shareholder. In some cases, transferring the policy as a dividend-in-kind may produce the best tax result for both the corporate transferor and, as discussed below, the transferee shareholder. Where the policy is transferred as a dividend-in-kind, no consideration is involved so the proceeds are based on the greater of the policy's ACB and CSV[ii]. A dividend-in-kind may also provide the corporation with the opportunity to regain refundable taxes paid on passive income.
- **Pursuant to a share redemption** – Where a corporation transfers a policy as payment for the redemption price of shares, the FMV of consideration given for the policy is the amount the shareholder is entitled to from having their shares redeemed (the aggregate redemption amount).
- **To an employee** – In most cases, the transferred policy is considered a bonus, or other form of remuneration. As a result, for tax purposes, the proceeds to the employer is an amount equal to the FMV of the policy, less any consideration paid by the employee. The corporation may deduct for tax purposes an amount equal to the policy's FMV as an employee taxable benefit, less any amount paid by the employee.

Tax consequences to an individual shareholder

Transfers for no value

If the shareholder didn't pay anything for the policy, or paid less than FMV, there may be a taxable shareholder benefit under subsection 15(1) of the Act. The benefit amount would be equal to the policy's FMV, less any amount paid by the shareholder for the policy. Taxable shareholder benefits are treated as regular income. The corporate transferor isn't entitled to a corresponding tax deduction equal to the taxable shareholder benefit amount.



The new ACB of the policy to the shareholder is generally an amount equal to the policy's FMV less any consideration given by the shareholder for the policy. The ACB is determined by the sum of the following two components:

1. The deemed proceeds received by the corporate transferor – meaning it will be an amount equal to the greatest of the FMV of the consideration given for the policy, policy's CSV and ACB.
2. The excess of the FMV of the policy over the figure from previous calculation, that's treated as a taxable shareholder benefit[iii].

Transfer as a dividend-in-kind

If the policy is transferred as a dividend-in-kind, the policy's FMV will be included in the shareholder's income and subject to tax at lower dividend tax rates[iv]. The ACB of the policy to the individual shareholder would be equal to the deemed proceeds received by the corporate transferor – meaning in this context it will be an amount equal to the greater of the policy's CSV and ACB[v].

Tax consequences to the corporate shareholder

Transfers for no value

If the corporate shareholder didn't pay anything for the policy, or paid less than FMV, there may be a taxable shareholder benefit under subsection 15(1) of the Act. The benefit amount would be equal to the FMV of the policy, less any amount paid by the shareholder for the policy. The policy's ACB to the corporate shareholder is calculated in the same manner described above in the case of the individual shareholder.

Transfer as dividend-in-kind

If the policy is transferred as a dividend-in-kind and the corporate shareholder is connected to the policyowner, the corporate shareholder may receive the policy as a tax-free intercorporate dividend. The income to the shareholder – on receipt of the policy as a dividend-in-kind – is an amount equal to the policy's FMV. Corporate dividend recipients that are connected to the corporate transferor will be able to claim an offsetting deduction, resulting in a tax-free dividend[vi]. Corporations are connected if they're under common control or if the dividend recipient owns more than 10% of the votes and value of the dividend payor.

A tax professional should consider the application of subsection 55(2) of the Act whenever a corporate-owned policy is transferred as a dividend-in-kind to another corporation. It's a broad and complex anti-avoidance rule that can change the tax-free character of an intercorporate dividend into a taxable capital gain.

The policy's ACB to the corporate shareholder would be equal to the deemed proceeds received by the corporate transferor – meaning it will be an amount equal to the greater of the policy's CSV and ACB[vii].

FMV of a life insurance policy

The life insurance policy's FMV is an important figure for these types of transactions. Generally, insurers don't provide the FMV for life insurance policies. Consulting actuaries specializing in policy valuations provide this service for a fee ranging from $1,000 to $2,500 per policy. Determining the FMV of a life insurance policy involves many factors. The policy FMV will typically be an amount somewhere between its CSV and insurance payout (death benefit). According to *Information Circular 89-3*, the Canada Revenue Agency (CRA) considers the following factors when valuing a life insurance policy:

- CSV
- policy's loan value
- face value
- state of health and life expectancy of the insured
- conversion privileges
- replacement value and policy terms, such as term riders;
- double indemnity provisions

Example – moving a policy from a subsidiary corporation to a shareholder

Let's look at the details of Christine's structure which ties in all these rules.

Christine owns a holding company (Holdco), which owns an operating company (Opco) carrying on a thriving sports agency business. The business will soon be bought by a larger competitor. Opco owns a universal life insurance policy on

Christine's life that she would like to keep. Opco purchased the policy several years ago and it has a very competitive annual premium with a $1 million insurance payout, ACB of $60,000, CSV of $10,000 and a policy FMV of $100,000. Her marginal tax rate is 46% for non-eligible dividend income and 52% for regular income.

Christine wants to simplify her estate planning by owning the policy personally, so her tax advisor gives her two options for dealing with the policy:

1. Opco transfers the policy to her for no consideration: taxable benefit, personal tax cost $52,000[viii], no tax cost to Opco.
2. Opco transfers the policy as a dividend-in-kind to Holdco and Holdco then transfers the policy to her as a dividend-in-kind: personal tax cost $46,000, no tax cost to Opco or Holdco[ix].

Either option requires a valuation of the policy. Christine chooses the second option which has the lowest tax cost. Her tax savings from using the lifetime capital gains exemption on the sale will more than offset her tax costs from receiving the policy personally[x]. The following table shows the tax consequences of each transfer:

	Option 1 ($)	Option 2 ($)	
	Opco transfer to individual for no consideration	**Step 1** Opco dividend-in-kind transfer to Holdco	**Step 2** Holdco dividend-in-kind transfer to individual shareholder
Starting ACB	60,000	60,000	60,000
Proceeds	60,000	60,000	60,000
Policy gain	0	0	0
Income inclusion for recipient	100,000	100,000	100,000
Tax cost (52 per cent regular income/46 per cent dividend income)	52,000	0	46,000
Initial ACB to shareholder	100,000	60,000	60,000

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

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[i] At the time of writing, there isn't a provision in the *Income Tax Act* that permits a tax-deferred transfer (a rollover) of a life insurance policy to or from a corporation.
[ii] CRA document 2016-0671731E5, dated June 7, 2017.
[iii] 2003 CALU Conference, Question 4, CRA document 2003-0004275, dated June 9, 2003.
[iv] The "grossed-up' amount of the dividend is included in the shareholder's income.
[v] 2017 CLHIA Conference, CRA document 2017-0690331C6, dated May 18, 2017.
[vi] Subsection 112(1) of the Act.
[vii] CRA document 2000-0056205, dated April 10, 2001.
[viii] Subsection 246(1) of the Act may give rise to the income inclusion in this case because she isn't a direct shareholder. Alternatively, Holdco may have an income inclusion pursuant to either subsections 15(1) or 56(2) of the Act.
[ix] In this example, for each transfer that's structured as a dividend-in-kind the deemed proceeds will be an amount equal to the ACB of the policy, resulting in no policy gain to the transferor.
[x] Each option results in Christine personally owning shares that she'll sell to the buyer. To access the capital gains exemption, an individual must sell a "qualified small business corporation share" (subs. 110.1(6) of the Act). The capital gains exemption is unavailable where a holding company sells shares of an operating company to a buyer.

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