The Institute for Advanced Financial Education

COMMENT

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Compliments of: Raymond Matt, CFP, CLU, TEP, CHS
Tel: 705-526-2807 Cell: 416-452-2334
www.csiplan.ca

CAN A CORPORATE-OWNED LIFE INSURANCE POLICY BE PAID AS A DIVIDEND IN-KIND?

There may be times when there is a need to transfer a life insurance policy from a corporation to an individual shareholder or from one corporation to another. At a recent Canada Life and Health Insurance Association meeting, the Canada Revenue Agency (CRA) was asked to clarify what the result would be if a corporation paid a dividend in-kind through the transfer of a life insurance policy from the corporation to its shareholder.

The CRA's response was that the corporation would be deemed to have received proceeds equal to the greatest of:

- cash surrender value;
- adjusted cost basis; and,
- fair market value of the consideration received.

When a dividend in-kind is paid, there is no consideration changing hands. This means the formula is reduced to the greater of cash surrender value and adjusted cost basis of the policy. The company would realize a policy gain to the extent the cash surrender value was greater than the adjusted cost basis of the policy.

The CRA held that the shareholder receiving title to the life insurance policy as a dividend in-kind would have a starting adjusted cost basis equal to the transferor's deemed proceeds of disposition.

However, the CRA went on to say the shareholder would have to recognize the dividend received at the fair market value of the policy transferred. They did not address the type of dividend that could be designated for the amount of the difference between fair market value and the deemed proceeds of disposition (i.e., eligible, ineligible or capital). A point of significant interest is that there was no mention of this transaction being subject to any surplus stripping or anti-avoidance measures.

Consider the following example and results:

	Example One	Example Two	Example Three
Face amount	$500,000	$500,000	$500,000
Cash surrender value	$50,000	$150,000	$150,000
Adjusted cost basis	$100,000	$100,000	$100,000
Consideration paid	Nil	Nil	Nil
Fair market value	$100,000	$150,000	$200,000
Deemed proceeds of disposition	$100,000	$150,000	$150,000
Gain realized by transferor	Nil	$50,000	$50,000
Starting ACB for transferee	$100,000	$150,000	$150,000
Dividend income to transferee	$100,000	$150,000	$200,000

In example one, the ACB is higher than or equal to the CSV and FMV. The policy's ACB is preserved and becomes the new owner's starting ACB.

In example two, the CSV is higher than or equal to the ACB and FMV. This creates an income inclusion for the transferor and bumps the ACB to $150,000 for the transferee.

In the third example, the policy's FMV is in excess of the deemed proceeds to the transferor and the transferee's deemed ACB. The CRA notes in their correspondence that it was not clear that this result was intended in terms of tax policy and they were referring the issue to the Department of Finance for subsequent policy consideration.

This technical interpretation from the CRA was in respect of a company paying a dividend in-kind to a shareholder who was an individual. Using the CRA's same logic, consider the situation where an operating company pays a dividend in-kind to its shareholder who is a holding company. The holding company would have a starting ACB equal to the deemed proceeds to the transferor, which could be less than the amount of dividend recognized as income.

Transferring title of an insurance policy is very common. While the rules for determining the deemed proceeds are new, there will be unique issues that are not always easily determined and may require additional research.

CRA STANCE RESULTS IN UNFAIR OUTCOME TO TAXPAYER

The 2016 Federal Budget introduced legislative changes to the calculation of the capital dividend account in respect of life insurance proceeds received by a corporation.

The new rules require that the credit to the capital dividend account arising from the receipt of life insurance proceeds be calculated as the amount of life insurance proceeds received in excess of a policyholder's adjusted cost basis (ACB) of the policy. This means that the policy's ACB will be used in the calculation regardless of the relationship of the beneficiary to the policy owner.

For example, assume a holding company (Holdco) owns a life insurance policy and names its subsidiary (Opco) as the beneficiary of the policy. When Opco receives the life insurance proceeds, it will calculate the credit to its capital dividend account as life insurance proceeds received in excess of Holdco's ACB. If the life insurance proceeds paid to Opco are $100,000 and Holdco's ACB is $7,500, the credit to Opco's capital dividend account is $92,500 ($100,000 of proceeds less the policy's ACB of $7,500).

At a recent Canada Life and Health Insurance Association meeting, a question was posed to the Canada Revenue Agency (CRA) requesting clarification of this provision. The CRA was asked what the result would be if a holding company owned a life insurance policy and named two of its subsidiaries, OpcoA and OpcoB, as equal beneficiaries of the life insurance policy. Since there was only one life insurance policy and one ACB, the industry was looking for the CRA's view on how the ACB would be allocated in this particular circumstance.

To the surprise of many, the CRA's response was that when there are multiple beneficiaries designated under a single policy it was their view that each beneficiary would include the entire ACB in the calculation of their capital dividend account. Applying the CRA's approach, the credit to the capital dividend account is reduced multiple times by the same amount (policy ACB) when there is more than one corporate beneficiary.

Using the CRA's view, let's look at an example. Holdco owns a life insurance policy that results in the payment of $100,000 of proceeds divided as 60% and 40% to the two operating companies owned by Holdco. OpcoA receives $60,000 and OpcoB receives $40,000. Holdco's ACB is $7,500 at the time the life insurance proceeds are paid. Below is a summary of how the CDA credit will be calculated.

	OpcoA	OpcoB	TOTAL
Life insurance proceeds received	$60,000	$40,000	$100,000
Less: A policy-holder's adjusted cost basis	$7,500	$7,500	$7,500
Credit to their capital dividend account	$52,500	$32,500	$85,000

The CRA's view reflects a strict reading of the provision. The provision as drafted does not appear to contemplate possible business scenarios, particularly as it relates to multiple beneficiary situations. Consider the following examples of situations where the CRA's view creates an unfair outcome.

Example One

A parent is the owner of Holdco, which in turn owns a life insurance policy and fixed value preferred shares of OpcoA and OpcoB. The common shares of OpcoA and OpcoB are owned by different children each with their own business plan. The life insurance owned by Holdco names OpcoA and OpcoB as beneficiaries of the policy. The purpose of this arrangement is to fund a redemption of the preferred shares. By redeeming the preferred shares, each child gains independence from the family and the value of preferred shares in Holdco is converted to cash to support the other estate planning needs of the parent.

In this example, the children were active in the family-owned business and a transfer of ownership from the parent is a logical and valid business and succession plan. It is common and a reasonable strategy for family businesses to use life insurance to help fund succession costs.

Example Two

A business owner might use a Holdco above several Opcos in order to creditor protect the situation by not holding hard assets in the operating companies. If one of the operating companies should need financial support, the arrangement is that Holdco would provide that support. One such way to provide support is to name the Opcos as beneficiaries for a portion of life insurance owned by Holdco. In this type of structure, an insurance arrangement is commonly required under each of the Opcos borrowing arrangements with their lenders.

Example Three

Two partners in business may hold their shares of Opco in each of their holding companies. Their buy-sell arrangement might say that each partner is to buy life insurance on their life and hold it in their individual Holdco naming Opco as beneficiary for the amount necessary to fulfill the buy-sell arrangement. Each of the partners could decide to buy extra insurance for individual needs or to have sufficient coverage should the value of Opco rise over time. Each of the Holdcos would name Opco for a portion of the insurance proceeds and their respective Holdco for the excess.

Even though there are legitimate reasons for naming multiple corporations as beneficiaries of a single life insurance policy, a conscious review of these arrangements would be advisable in light of the CRA's position on this issue.

2017 TAX RATES FOR A CCPC

In Canada, Canadian Controlled Private Corporations (CCPCs) pay tax at different rates on several types of income. To begin with, income earned by a CCPC is classified as either active business income, passive investment income or dividend income. In addition, a CCPC is entitled to claim the small business deduction, which results in a low-rate of tax on the active business income earned up to the small business limit (SBL). A CCPC pays a high-rate of tax on passive investment income (PII), but some of the tax is refundable when taxable dividends are paid.

The following table reflects the current tax rates for different types of income within a CCPC. It should be noted that a corporation would pay a blended rate of tax depending on its year-end and those portions of its fiscal year between tax changes.

	SBL	Tax Rate on Income Up to the SBL	Tax Rate on Income Above SBL	Tax Rate on PII
	A	B	C	D
British Columbia	$500,000	12.50%[2]	26.00%	49.67%
Alberta	$500,000	12.50%	27.00%	50.67%
Saskatchewan	$500,000	12.50%	26.50%[3]	50.17%[3]
Manitoba	$450,000	10.50%	27.00%	50.67%
Ontario	$500,000	15.00%	26.50%	50.17%
Quebec	$500,000	18.50%[1]	26.80%	50.33%
New Brunswick	$500,000	13.50%[2]	29.00%	52.67%
Prince Edward Island	$500,000	15.00%	31.00%	54.67%
Nova Scotia	$500,000	13.50%	31.00%	54.67%
Newfoundland	$500,000	13.50%	30.00%	53.67%
North West Territories	$500,000	14.50%	26.50%	50.17%
Yukon	$500,000	13.50%[3]	27.00%[3]	50.67%
Nunavut	$500,000	14.50%	27.00%	50.67%

Notes:
1 This table shows a single rate. There are, however, a series of circumstances under which the rates could differ from that shown.
2 As of April 1, 2017, New Brunswick and British Columbia
3 As of July 1, 2017, Saskatchewan and Yukon

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Examples of passive investment income include interest income, taxable capital gains, rental income and policy gains on insurance policies. The tax rates shown for passive investment income in column D, include a refundable portion of tax set at 30.67%. The full PII tax rate is applied to any PII income earned and 30.67% of the rate shown is set aside in a notional account. The corporation is entitled to a refund from the notional account when taxable dividends are paid. For every $10 of taxable dividends paid, the corporation receives a refund of $3.83 from the notional account.

In simple terms, the high rate of tax paid by the corporation on passive income is reduced through a refund of taxes previously paid when the company pays taxable dividends. This acts as an incentive to have a full flow-through of income out to the shareholder rather than damming up income within the corporation. Effectively, the actual rate of tax paid on passive income is the rate shown in column D less 30.67%, on the assumption taxable dividends eventually flow out to the shareholders of the corporation.

EXAMPLE

JBC Inc (JBC) is a CCPC operating in Ontario. JBC's fiscal year-end is December 31, 2017. During the 2017 fiscal year, JCB earns total income of $1,000,000, of which $900,000 is active business income and $100,000 is passive income.

	SBL	Tax Rate on Income Up to the SBL	Tax Rate on Income Above SBL	Tax Rate on PII
	A	B	C	D
Ontario	$500,000	15.00%	26.50%	50.17%

JBC's total income is	$1,000,000	
JBC's income tax payable		
• ABI up to $500,000	$500,000 x 15% (column B)	$75,000
• ABI beyond $500,000	$400,000 x 26.50% (column C)	$106,000
• Passive income	$100,000 x 50.17% (column D)	$50,170
	TOTAL TAX	$231,170

JBC's addition to its notional refundable tax account

- 30.67% of the $100,000 of passive income $30,670

Assume JBC pays total taxable dividends of $85,000 to its shareholders in 2018. This will result in a refund to JBC of the balance ($30,670) in its notional refundable tax account. This is calculated as a $3.83 refund for every $10 of taxable dividends paid. Refunds from the notional refundable tax account occur only through the payment of taxable dividends, so the payment of a capital dividend would not result in a refund for JBC.

New net tax paid by JBC is $200,500, assuming sufficient taxable dividends are paid to warrant a full refund from the notional refundable tax account.

- $30,670 is the balance in the notional account
- $80,009 of taxable dividends paid would allow for a refund of the $30,670 balance in the notional account
- In this example, JBC paid $85,000 of taxable dividends (more than needed), so will be entitled to a full refund of the $30,670 balance.

New net tax paid by JBC is $200,500.

Authors:

James W. Kraft, CPA, CA, MTAX, TEP, CFP, FEA, CLU
Deborah Kraft, MTAX, LLM, TEP, CFP, CLU

Published by:

The Institute
390 Queens Quay West, Suite 209
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.iafe.ca • info@iafe.ca

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