# LIFE INSURANCE TRANSFERS

MARCH 2023

## TAX IMPLICATIONS OF A LIFE INSURANCE POLICY TRANSFER

### BACKGROUND

Life insurance needs for both individuals and the corporations they own are not static. These needs evolve as family, and financial situations change.

In certain situations, transferring the interest in an existing policy to a new owner may be one solution to consider.

Whether during the policyholder's lifetime, death, or as part of a transaction involving corporations, the tax implications of a transfer of interest are sometimes difficult to assess.

The transfer of a life insurance policy's ownership raises legal and tax concerns. These questions often arise in a financial planning context, and the answers will vary depending on the parties involved in the transaction.

Whether or not the parties are dealing at arm's length can also affect the outcome of the process.

This newsletter aims to provide a high-level overview of some of these issues. It will include examples to help illustrate the tax implications of life insurance policy transfers.

**In this newsletter**

- What constitutes a disposition of a Life Insurance Policy?
- Who is liable for the tax due, if any?
- When is a tax-free rollover available?
- What are the tax implications of a transfer between a business corporation and a shareholder or employee?

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### RULES FOR LIFE INSURANCE POLICY TRANSFERS

The policyholder may transfer their interest in a life insurance policy to another individual or corporation.[1]

#### GENERAL RULES

A life insurance policy transfer is a **disposition** within subsection 148(9) of the *Income Tax Act (ITA)*.

Subsection 148(1) sets out the general rules that apply to the computation of tax concerning a disposition.

A life insurance policy transfer may trigger a policy gain, which is taxable in the hands of the transferor. The policy gain is equal to the proceeds of disposition minus the adjusted cost basis (ACB) of the interest in the life insurance policy. This gain is fully taxable as ordinary income.

It is essential to understand that a life insurance policy is not capital property since the ITA explicitly excludes them from assets that give rise to a capital gain or loss.[2]

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A taxpayer who disposes of his interest in a life insurance policy does not realize a capital gain; if it is a policy gain, the taxpayer cannot claim any losses, and the entire gain is income.

## SPECIFIC RULES

Subsection 148(7) contains specific rules overriding the abovementioned general rules. These rules apply when an interest in a life insurance policy is disposed of or by:

- distribution from a corporation;
- gift, either while living or by will;
- transfer by operation of law only; and
- transfer in any manner to any person with whom the transferor is not dealing at arm's length.

In this case, the notion of persons not dealing at arm's length is broader than related persons.

Generally, the idea of ***not at arm's length*** refers to persons who are connected by:

- blood relationship;
- marriage, as common-law partners; or
- by adoption.

In addition, a "non-arm's length" relationship may also exist between an individual and a corporation, a trust, or two corporations.[3]

For example:

- **a corporation and a person** who controls the corporation;
- a person who is **a member of a related group** that controls the corporation; or
- two corporations controlled by the same person, or group of persons

are all deemed to deal "not at arm's length."

Even where a shareholder does not control the corporation, if they do not pay the fair market value (FMV) for the policy, the transfer may be deemed to be a non-arm's length transaction or distribution, which would be subject to the application of subsection 148(7).

For transfers taking place after March 21, 2016, in a non-arm's length context, subsection 148(7) states that the ***proceeds of disposition*** to the transferor and the new ***adjusted cost basis (ACB)*** to the transferee will be equal to the highest of the following amounts:

- the ***value*** of the interest in the policy at the time of the disposition;
- the ***fair market value (FMV)*** of any consideration given for the interest in the policy; and
- the ***adjusted cost basis (ACB)*** to the policyholder of the interest in the policy immediately prior to disposition.

Subsection 148(9) defines **value** as the amount the policyholder would be entitled to receive if the policy were surrendered, which is essentially the ***cash surrender value (CSV)*** of the policy minus any unpaid policy loans.

Lastly, subsection 148(7) does not require that the FMV of the life insurance policy be paid at the time of transfer. A disposition instead looks at the FMV of the consideration paid to acquire the policy when it is transferred.

However, the FMV of the policy will still have to be considered for calculating shareholder benefits under subsection 15(1), or for valuation of a dividend payable in kind.

## ADJUSTED COST BASIS OF A LIFE INSURANCE POLICY

The overall concept of ***adjusted cost basis (ACB)*** is defined in the *Income Tax Act*.[4] The adjusted cost basis represents the cost of the interest the policyholder has acquired in a life insurance policy. This is the base value from which policy gains will be calculated.

However, the ACB of a policyholder's interest in a life insurance policy is calculated according to a complex formula set out in the definition of adjusted cost basis in subsection 148(9). This amount may vary depending on the acquisition date of the policy, the nature of the policy (which could be a life insurance

policy or an annuity), and any transactions that have taken place on the policy, such as policy loans or the payment of dividends.

It is increased by certain factors, such as the amount of premiums paid, and it is reduced by others, such as the net cost of pure insurance (NCPI).[5]

The amount representing the ACB of the policy may not, however, be negative. Information about the ACB amount is usually available through the insurer that issued the policy.

## ADJUSTMENT TO ACB AFTER A LIFE INSURANCE POLICY TRANSFER

A *strict* reading of the definition of ***adjusted cost basis*** in subsection 148(9) indicates that a taxable benefit must be added to the ACB of the policy acquired by a shareholder or employee. Therefore, the ACB of the policy to the transferee would be the cash surrender value (CSV) of the policy plus the value of any taxable benefit included in the transferee's income.[6]

*However,* the **Canada Revenue Agency (CRA)** revised its initially strict position. It indicated that a strict application of this provision could produce an inappropriate outcome for the transferee, in that the ACB may exceed the FMV of the interest in the policy. Therefore, the calculation of the ACB may need to be reviewed.

The CRA has since indicated that where subsection 148(7) applies and the transferee is required to include a taxable benefit in income, only the excess of the FMV of the policy over the CSV will have to be added to the ACB of the policy to the transferee.[7]

## TAXABLE BENEFIT TO SHAREHOLDER EMPLOYEE

When a life insurance policy is transferred, it is important to look at whether a taxable benefit will be assessed to a shareholder or employee.

The CRA states that a taxable benefit may be conferred on a shareholder under the provisions of subsection 15(1), or on an employee under the provisions of paragraph 6(1)(a).

The taxable benefit must be added to the transferee's taxable income when the policy's FMV exceeds the consideration paid by the shareholder or employee[8] to acquire the policy.

To prevent a taxable benefit from being conferred, the shareholder or employee would have to pay the corporation an amount equal to the FMV of the life insurance policy.

## FAIR MARKET VALUE OF A LIFE INSURANCE POLICY

As we have seen, there are various situations that require determining a life insurance policy's ***fair market value (FMV)***. The CRA has indicated that life insurance policies must be valued at their fair market value.

We know that this value does *not* necessarily correspond to the policy's cash surrender value and that it will depend on several factors.

CRA *Information Circular 89-3, entitled "Policy Statement on Business Equity Valuations,"* outlines certain valuation principles.[9]

According to these guidelines, there are a number of factors to be considered in correctly determining the fair market value of a life insurance policy, including:

- the policy's cash surrender value and face value;
- the state of health and insurability of the insured and his/her life expectancy;
- conversion privileges, riders and other provisions;
- replacement value and the type of policy involved.

Valuation of a policy's fair market value should always be carried out by an independent professional.

## TAXES PAYABLE BY POLICYHOLDER ON TRANSFER

The insurer is required to indicate on a T4 or T5 slip the taxable amount the initial policyholder (transferor) has to include in income for the taxation year in which the disposition took place.

Under tax legislation, when a policyholder disposes of an interest in a life insurance policy in a given taxation year, he must include in his taxable income for that year the taxable portion of the proceeds from the disposition of the policy.[10]

The policyholder must include the full amount of the taxable portion on his income tax return.

## TRANSFERS BETWEEN INDIVIDUALS

There are many transactions in which individuals may be involved. A popular but mistaken belief is that a taxable disposition at death can be prevented by appointing a contingent owner on the policy.

It is important to remember that transferring ownership to an individual, whether during the policyholder's lifetime or at death, constitutes a disposition by operation of law.[11]

The transfer will take place on a tax-free basis only if the subsequent owner qualifies under the ITA as someone who is deemed to acquire the policy for an amount equal to its ACB.

### TAX-FREE TRANSFERS

In the ITA a life insurance policy can be transferred on a tax-free basis in certain situations.

In that context, the transferor is deemed to have disposed of the policy in exchange for proceeds of disposition equal to the policy's ACB, and the transferee is deemed to have acquired the interest in the policy at a cost equal to those proceeds (ACB).

The ITA allows tax-free policy transfers to a:

- spouse during policyholder's lifetime;
- spouse at policyholder's death; and
- child.

#### TRANSFER TO SPOUSE DURING POLICYHOLDER'S LIFETIME

Under subsection 148(8.1) a tax-free policy transfer is allowed when a policy is transferred during the policyholder's lifetime to the policyholder's married spouse or common-law partner.

It can also transfer to the former spouse or common-law partner when the transfer is in settlement of rights arising out of the marriage or common-law partnership.

In order for there to be no tax impact, both the policyholder, and spouse or common-law partner, must be residents of Canada at the time of the transfer.

The policyholder may elect *not* to take advantage of a tax-free transfer. In that case, subsection 148(7) would apply and the *proceeds of disposition* would be equal to the *highest* of the following amounts:

- the policy's cash surrender value,
- the FMV of consideration paid for the policy, and
- the policy's ACB.

However, even though a transfer to a spouse does not have any immediate tax implications for the transferor, it must be kept in mind that during the policyholder's lifetime, if the spouse-beneficiary accesses the cash surrender value via a policy loan or otherwise, it may cause the attribution rules to be applied to the income generated, unless the person is a former spouse.[12]

#### TRANSFER TO SPOUSE AT POLICYHOLDER'S DEATH

Under subsection 148(8.2), a policy transfer at the policyholder's death to the policyholder's married spouse or common-law partner is tax-free.

In order for there to be no tax impact, the policyholder and spouse must be residents of Canada at the time of the transfer.

There are certain situations that call for special attention.

Firstly, ***common-law partners*** as defined under the *Income Tax Act* may not have an automatic right to such an inheritance as it depends on the provincial law in force.

Secondly, the estate liquidator may elect to not take advantage of a tax-free transfer. In that case, subsection 148(7) would apply and the proceeds of disposition would be similar to that of a transfer while living mentioned above.

Lastly, it should be noted that the right of survivorship that applies to joint owners of an asset under common law[13] does not exist in the Civil Code of Quebec.[14]

### TRANSFER TO A CHILD

Subsection 148(8) allows for a tax-free rollover to a ***child*** when the following two conditions are met:

- the policy is transferred to the policyholder's child for no consideration, and
- the life insured is a child of the policyholder or a child of the transferee.

For the purposes of the ITA, the term ***child*** also includes grandchildren, great-grandchildren, the married spouse or common-law partner of a child, a child of the taxpayer's married spouse or common-law partner, or an adopted child.[15]

The child to whom the policy is transferred does not necessarily have to be the person insured under the policy. Thus, a grandparent who owns a policy under which his son is insured may transfer that policy to his grandson with no tax implications.

If the conditions are satisfied, a life insurance policy can be transferred on a tax-free basis. There are no restrictions[16] as to the timing of the transfer.

The policy must be transferred to the child directly. It cannot be transferred to a trust, even if the beneficiary under the trust is a child who would otherwise qualify for a rollover.[17] Also, the CRA has stated that a rollover is not allowed if the policy is transferred to the owner's child and the owner is the insured under the policy.[18]

At first glance, it would appear that these rollover situations are easily applied. However, subsection 148(8) ITA, which allows tax-free rollovers, does not apply to an insurance policy transferred from parent to child by means of the policyholder's will.[19]

Thus, upon the policyholder's death, the policy will first be transferred to the estate, and then to the child. This situation will result in the disposition of the policy by the deceased policyholder, and any gain realized on the policy will have to be included in the final tax return for the deceased.

One way around this is to name a contingent owner in the policy who is the insured child or a child of whom the insured is a child. The CRA has confirmed that a rollover would be allowed[20] where the insured child is named the contingent owner, as the policy will then not form part of the deceased owner's estate but will instead be transferred directly to the child named as contingent owner.

It should be noted that a transfer to a child should not be made unless the child is the age in their province in which they are deemed able to deal with a contract of insurance.

| OWNER | INSURED | NEW OWNER | ROLLOVER |
|---|---|---|---|
| Taxpayer | Child | Child | Yes |
| Taxpayer | Child | Grandchildren | Yes |
| Taxpayer | Grandchildren | Child | Yes |
| Taxpayer | Parent | Child | No |
| Taxpayer | Grandparent | Grandchildren | No |

## TRANSFERS WITH A CORPORATION

Corporations often own insurance policies on the lives of their shareholders and employees. In many cases, it is advantageous for the shareholder or employee to receive the policy after the corporation is sold or wound up, or after employment is terminated.

The tax implications, however, will be different depending on whether the parties are dealing at arm's length.

Using the following information, let's look at the impact of various types transfers of a life insurance policy.

| UNIVERSAL LIFE INSURANCE POLICY | |
|---|---|
| Insurance amount: | $ 1,000,000 |
| Cash Surrender Value (CSV) | $ 150,000 |
| Adjusted Cost Basis (ACB) of policy | $ 75,000 |
| Fair Market Value (FMV) of policy | $ 500,000 |

### TRANSFER FROM A CORPORATION TO A SHAREHOLDER OR EMPLOYEE

A corporation (OPCO) owns a life insurance policy on a shareholder. When the shareholder leaves, the corporation will probably no longer need to have insurance on the shareholder.

However, the shareholder may want to keep the policy. The corporation may therefore wish to transfer ownership of the policy to the departing shareholder.

As we have seen, the transfer would be a disposition for tax purposes. Since the transfer is between parties not dealing at arm's length, subsection 148(7) will apply.

Under this subsection, the transaction is subject to the following tax rules:

- The proceeds of disposition for the corporation will be the highest of the:
    - value (CSV) of the policy,
    - FMV of the consideration paid by the shareholder to acquire the policy, and
    - ACB of the policy.
- The new ACB to the shareholder is deemed to be equal to the proceeds of disposition; and
- Any difference between the FMV of the policy and the amount paid as consideration for the transfer will be considered a taxable benefit to the shareholder.

Let's look at the potential tax impact of this transaction in various scenarios.

SCENARIO 1: The corporation transfers the life insurance policy to the shareholder for no consideration.

SCENARIO 2: The corporation transfers the life insurance policy to the shareholder, who pays the corporation consideration equal to the cash surrender value of the policy ($150,000).

SCENARIO 3: The corporation transfers the life insurance policy to the shareholder, who pays the corporation consideration equal to the fair market value of the policy ($500,000).

| TRANSFEROR: OPCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Proceeds *deemed disposition 148(7)* | $ 150,000 | $ 150,000 | $ 500,000 |
| Adjusted Cost Basis (ACB) | $ 75,000 | $ 75,000 | $ 75,000 |
| ***Policy Gain (Income)*** | ***$ 75,000*** | ***$ 75,000*** | ***$ 425,000*** |

| TRANSFEREE: SHAREHOLDER | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Consideration Paid | NIL | $ 150,000 | $ 500,000 |
| ***Taxable Benefit*** | ***$ 500,000*** | ***$ 350,000*** | ***NIL*** |
| New ACB | $ 500,000 | $ 500,000 | $ 500,000 |

In SCENARIO 1 and SCENARIO 2, the result would be a taxable benefit equal to the amount by which the policy's FMV exceeds its cash surrender value or the consideration paid,[21] and this would have to be added to the transferee shareholder's taxable income[22] pursuant to subsection 15(1) or paragraph 6(1)(a).

To prevent a taxable benefit from being conferred, the shareholder would have to pay the corporation an amount equal to the FMV of the life insurance policy as in SCENARIO 3.

The assessment of a taxable benefit can be reduced or eliminated if the life insurance is transferred as a dividend payable in kind to the shareholder. The dividend amount would be equal to the fair market value of the policy and will be taxable at the dividend rate for the shareholder.

In SCENARIO 1 and SCENARIO 2, the existence of a taxable benefit means there would have to be an adjustment to the policy's ACB to reflect the amount by which the policy's FMV exceeds its CSV. This amount would have to be added to the policy's ACB. The ACB adjustment has been confirmed by various CRA technical interpretations.[23] As a result, the ACB to the transferee would be $500,000.

## TRANSFER FROM AN OPERATING COMPANY TO A HOLDING COMPANY

Corporate restructuring or the sale of an operating company will often lead to a change in the ownership structure of any life insurance involved.

One common arrangement is for an **operating company (OPCO)** that is owned by a **holding company (HOLDCO)** to transfer ownership of a life insurance policy to the holding company.

In this situation, subsection 148(7) ITA will apply, as the transfer is a non-arm's length transfer.

As a result, the proceeds of disposition for the operating company will be the highest of the:

- value (CSV) of the policy,
- FMV of the consideration paid by the shareholder to acquire the policy, and
- ACB of the policy.

The new ACB to the holding company is deemed to be equal to the proceeds of disposition.

Lastly, the difference between the FMV of the policy and the amount paid as consideration for the transfer will be considered a taxable benefit to the transferee (HOLDCO) pursuant to subsection 15(1).

Let's look at the potential tax impact of this transaction in various scenarios.

SCENARIO 1: OPCO transfers the life insurance policy to HOLDCO for no consideration.

SCENARIO 2: OPCO transfers the life insurance policy to HOLDCO, which pays OPCO consideration equal to the cash surrender value of the policy ($150,000).

SCENARIO 3: OPCO transfers the life insurance policy to HOLDCO, which pays OPCO consideration equal to the fair market value of the policy ($500,000)

| TRANSFEROR: OPCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Proceeds *deemed disposition 148(7)* | $ 150,000 | $ 150,000 | $ 500,000 |
| Adjusted Cost Basis (ACB) | $ 75,000 | $ 75,000 | $ 75,000 |
| ***Policy Gain (Income)*** | ***$ 75,000*** | ***$ 75,000*** | ***$ 425,000*** |

| TRANSFEREE: HOLDCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Consideration Paid | NIL | $ 150,000 | $ 500,000 |
| ***Taxable Benefit*** | ***$ 500,000*** | ***$ 350,000*** | ***NIL*** |
| New ACB | $ 500,000 | $ 500,000 | $ 500,000 |

### BUT WHAT ABOUT DECLARING A DIVIDEND PAYABLE INSTEAD?

SCENARIO 4: OPCO declares a dividend payable in kind to HOLDCO in an amount equal to the fair market value of the policy ($500,000).

| TRANSFEROR: OPCO | |
|---|---|
| SCENARIO | 4 |
| Proceeds *deemed disposition 148(7)* | $ 150,000 |
| Adjusted Cost Basis (ACB) | $ 75,000 |
| ***Policy Gain (Income)*** | ***$ 75,000*** |

| TRANSFEREE: HOLDCO | |
|---|---|
| SCENARIO | 4 |
| Dividend In Kind | $ 500,000 |
| Taxable Benefit | NIL |
| ***New ACB*** | ***$ 150,000*** |

In SCENARIO 1 and SCENARIO 2, the taxable benefit that arises for HOLDCO cannot be deducted by the transferor corporation, OPCO. A taxable benefit should therefore be avoided if possible.

The assessment of a taxable benefit could, however, be reduced or eliminated if the life insurance policy is transferred as a dividend payable in kind as in SCENARIO 4. The amount of the dividend would be equal to the FMV of the policy ($500,000). The dividend could then be treated as a tax-free intercorporate dividend in kind.

Subsection 148(7) would still apply to deem the disposition and acquisition to take place at the greatest of the policy value, consideration given and ACB.

The CRA has confirmed in two technical interpretations that the shareholder does not give consideration to the corporation in respect of a policy transferred as a dividend in kind.[24]

The tax treatment applied to dividends in kind is discussed in *ARCHIVED Interpretation Bulletin IT-67R3, Taxable dividends from corporations resident in Canada*.

According to paragraph 6 in this Interpretation Bulletin, the dividend would be equal to the life insurance policy's FMV even though the proceeds of disposition and the new ACB may be a different amount.

Despite this possibility, it should be noted that subsection 55(2) could apply to recharacterize the intercorporate dividend in kind as a capital gain.

The 2015 federal budget expanded the application of subsection 55(2) to a number of common situations involving the payment of a dividend between related companies, including the payment of a dividend in kind in the context of transferring a life insurance policy between two related companies.

To prevent the application of subsection 55(2) and allow the transfer of the policy to the holding company without triggering a capital gain, there must be sufficient safe income (tax-paid retained earnings) attributable to the class of the operating company's shares used to pay the dividend in kind.

As the provisions of subsection 55(2) are extremely complex, the best course of action is to consult a tax professional before proceeding with this type of transaction.

## TRANSFER BETWEEN SISTER CORPORATIONS

In a context of a corporate restructuring, it might make sense to transfer a life insurance policy from one sister corporation to another.

As the transfer is a non-arm's length transfer, it will also be subject to the provisions of subsection 148(7) ITA. As in the preceding examples, the proceeds of disposition for the transferor corporation will be the highest of the following amounts: the value of the policy (i.e., the cash surrender value), the FMV of the consideration paid by the transferee corporation, and

the ACB of the policy. The new ACB to the transferee is deemed to be equal to the proceeds of disposition.

Let's look at a situation where OPCO owns an insurance policy on the life of a shareholder who is also a shareholder of SISTERCO. Following a restructuring of the business, OPCO wishes to transfer this policy to SISTERCO, let's look at the potential tax impact of this transaction in various scenarios.

SCENARIO 1: OPCO. transfers the life insurance policy to SISTERCO for no consideration.

SCENARIO 2: OPCO transfers the life insurance policy to SISTERCO, which pays OPCO an amount equal to the cash surrender value of the policy ($150,000).

SCENARIO 3: OPCO transfers the life insurance policy to SISTERCO which pays OPCO an amount equal to the fair market value of the policy ($500,000).

| TRANSFEROR: OPCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Proceeds *deemed disposition 148(7)* | $ 150,000 | $ 150,000 | $ 500,000 |
| Adjusted Cost Basis (ACB) | $ 75,000 | $ 75,000 | $ 75,000 |
| ***Policy Gain (Income)*** | ***$ 75,000*** | ***$ 75,000*** | ***$ 425,000*** |

| TRANSFEREE: SISTERCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Consideration Paid | NIL | $ 150,000 | $ 500,000 |
| ***Taxable Benefit*** | ***NIL*** | ***NIL*** | ***NIL*** |
| New ACB | $ 150,000 | $ 150,000 | $ 500,000 |

In the above example. the two corporations are not shareholders of one another. As a result, there can be no taxable benefit for the transferee corporation pursuant to subsection 15(1).

*However*, in the CRA's view, *the transfer between sister corporations may result in a taxable benefit to the shareholder of the transferee corporation*. This conclusion stems from comments made by the CRA in 2006, which applied a test for determining whether there was a shareholder benefit under subsection 15(1).[25] If the transferor corporation is impoverished and the sole shareholder of the transferee corporation is enriched, a taxable benefit could be assessed to the shareholder.

A transfer between sister corporations could also be deemed an indirect payment to the shareholder of the transferee corporation pursuant to subsection 56(2).

If any of these tax provisions apply, the taxable benefit to the shareholder would be equal to the amount by which the FMV of the policy exceeds the consideration paid, if any, by the sister corporation to acquire the policy.

## TRANSFER FROM A SHAREHOLDER TO A CORPORATION

For estate planning purposes, or as a result of corporate restructuring, a shareholder may wish to transfer his life insurance policy to a corporation that he controls. In such a case, the shareholder and his corporation would not be dealing at arm's length, meaning that subsection 148(7) will apply.

Under this subsection, both the proceeds of disposition to the transferor and the ACB to the transferee are deemed to be the highest of:

- value (CSV) of the policy,
- FMV of the consideration paid by the shareholder to acquire the policy, and
- ACB of the policy.

Let's look at the potential tax impact of this transaction in various scenarios.

SCENARIO 1: The shareholder transfers the life insurance policy to the corporation for no consideration.

SCENARIO 2: The shareholder transfers the life insurance policy to the corporation. which pays the shareholder an amount equal to the cash surrender value of the policy ($150,000).

SCENARIO 3: The shareholder transfers the life insurance policy to the corporation, which pays the shareholder an amount equal to the fair market value of the policy ($500,000).

| TRANSFEROR: SHAREHOLDER | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Proceeds *deemed disposition 148(7)* | $ 150,000 | $ 150,000 | $ 500,000 |
| Adjusted Cost Basis (ACB) | $ 75,000 | $ 75,000 | $ 75,000 |
| ***Policy Gain (Income)*** | ***$ 75,000*** | ***$ 75,000*** | ***$ 425,000*** |

| TRANSFEREE: OPCO | | | |
|---|---|---|---|
| SCENARIO | 1 | 2 | 3 |
| Consideration Paid | NIL | $ 150,000 | $ 500,000 |
| ***Taxable Benefit*** | ***NIL*** | ***NIL*** | ***NIL*** |
| New ACB | $ 150,000 | $ 150,000 | $ 500,000 |

**THE MARCH 2016 FEDERAL BUDGET SIGNIFICANTLY REDUCED THE TAX ADVANTAGES OF THIS TYPE OF TRANSACTION.**

However, transferring a life insurance policy from a shareholder to a corporation may still be a good idea. For example, it may be advantageous from a tax perspective to pay the premiums on the policy with corporate dollars, which are generally taxed at a lower rate.

Shareholders interested in this type of strategy would be well advised to accept consideration that is at least equal to the higher of the cash surrender value and the ACB of the policy, as applicable.

The shareholder in our example should therefore receive consideration in the amount of $150,000, as that value will have no additional impact on the policy gain indicated.

As a result of this transaction, the new ACB to the transferee corporation will be the highest of the following amounts:

- value (CSV) of the policy,
- FMV of the consideration paid by the shareholder to acquire the policy, and
- ACB of the policy.

Before transferring a policy to a corporation under their control, shareholders should also give some thought to the implications of the transaction. Factors to consider with this type of transfer include:

- the risk in terms of exposure to the creditors of the corporation, if any);
- if the life insurance policy has a substantial cash surrender value, this could impact the eligibility of the corporation's shares for the capital gains deduction to the shareholder;
- xare must be taken to avoid triggering an undesirable taxable benefit. To that end, the corporation should be designated as the beneficiary of the policy.
- The risk of double taxation at death if the policy has a substantial cash surrender value.

## IMPACT OF POLICY TRANSFERS AND PERSONAL TRUSTS

A trust can purchase a life insurance policy where permitted by the trust language. Upon the death of the insured person, the death benefit will be paid to the trust as beneficiary of the policy. It can then be distributed in accordance with the trust language.

A life insurance policy can be held in a trust for more than 21 years, as the 21-year deemed disposition rule applies only to the capital property of a trust.

### POLICY TRANSFER TO A PERSONAL TRUST

Section 73 and subsection 104(2) allow the rollover of property to a trust. A life insurance policy, however,

cannot be transferred under these provisions, as they both apply only in respect of capital property.

Similarly, the rules allowing a tax-free transfer of a life insurance policy to a spouse do not apply to allow a tax-free transfer of a life insurance policy to a spousal trust.[26] In this context, a policy transfer to the trust is subject to the application of subsections 148(1) and 148(7).

### POLICY TRANSFER FROM A PERSONAL TRUST TO THE BENEFICIARY

Like any other trust property, an interest in a life insurance policy can be transferred with no tax impact via a rollover to the beneficiaries of the trust capital where the conditions of subsection 107(2) are satisfied.[27]

According to the CRA, this subsection takes precedence over subsection 148(7), as it is more specific.[28]

In this context, the term ***capital*** is to be understood with reference to the trust language and does *not* mean capital property as defined in the legislation.

## AMALGAMATIONS AND WINDUPS

### IMPACT OF THE TRANSFER OF AN INTEREST IN A LIFE INSURANCE POLICY IN THE CONTEXT OF AMALGAMATION

Where two or more corporations are amalgamating and the provisions of section 87 apply, the new corporation, in respect of each of the amalgamated corporations, is deemed to be the same corporation.

As a result, the tax characteristics of the initial life insurance policy will continue to apply.[29]

Such a transaction would not constitute a disposition of an interest in a life insurance policy, given the continuation of the two corporations into one amalgamated entity.

### IMPACT OF THE TRANSFER OF AN INTEREST IN A LIFE INSURANCE POLICY IN THE CONTEXT OF WINDING UP A CORPORATION

In a case where a corporation is being wound up and a subsidiary is being absorbed by the parent corporation, the parent corporation, in respect of each subsidiary, is deemed to be the same corporation and a continuation of it, pursuant to subsection 88(1).

Therefore, if the applicable rules are followed, the initial life insurance policy could be transferred tax-free and vested rights would be protected for the policies owned by the subsidiary that are transferred to the parent corporation at the time of the winding-up.[30]

## POLICY TRANSFER BY A NON-RESIDENT

When a non-resident disposes of an interest in a "life insurance policy in Canada", any gain arising from the disposition is taxed as taxable income earned in Canada by a non-resident, pursuant to subparagraph 115(1)(a)(vi).

This subparagraph refers to an amount that would have been required to be included in respect of a life insurance policy in Canada by virtue of subsection 148(1) or 148(1.1).

## CONCLUSION

The tax implications of transactions performed on life insurance policies are often difficult to assess. Consequently, some situations will require you to seek the advice of actuarial and taxation specialists to ensure that the client is not leaving themselves open to an unexpected tax assessment.

When in doubt, it is always best to have the transaction validated before proceeding with a transfer.

## OTHER RESOURCES

- Income Tax Act Section 15     Section 148     Subsection 148(7)

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## ENDNOTES

1 Article 2418 of the Civil Code of Quebec’s civil law allows the assignment of an insurance contract to a third party, provided the assignee has an insurable interest in the life or health of the insured. If an insurable interest does not exist at the time of the transaction, the life insured must consent to the assignment in writing.
2 ITA subparagraph 39(1)(a)(iii)
3 ITA subsections 257(7), 257(2)
4 ITA paragraph 148(9) "adjusted cost basis"
5 Income Tax Regulations subsection 308(1)
6 1993 External Technical Interpretation 9327305 F – Transfer of Life Insurance Policy to Employee (originally in French)
7 2003 Income Tax Rulings Directorate 2003-0004275; 2013 External Technical Interpretation 2013-0481421C6.
8 1993 External T.I. 9327305 F
9 The CRA has stated that the valuation principles for a life insurance policy as set out in sections 40 and 41 of Information Circular 89-3 apply in all circumstances, and not only with respect to valuation in the context of a corporation.
10 ITA paragraph 56(1)(j)
11 ITA subsection 248(8)
12 ITA Subsection 74.1(1)
13 Generally, the right of survivorship is a right where, at death, the interest of the deceased joint owner is transferred to the surviving joint owner(s) by operation of law. In common law jurisdictions, it is important to note that insurance policies should expressly stipulate that the right of survivorship applies.
14 In Quebec, the proportion of the interest in a life insurance policy held by one of the owners will automatically form part of that person's estate, even if the other owner is the spouse. The spouses therefore have to appoint each other as the contingent owner of their interest in the policy, or ensure that there is a provision in their wills to address this situation.
15 The definition of "child" in this specific case is the definition found in ITA subsection 148(9), which itself refers to the definition in ITA subsection 70(10). An extended definition of "child" can be found in ITA subsection 252(1)
16 There is no Canadian residency requirement, as there is with spousal transfers
17 1999 External Technical Interpretation 9826715 – 148(8) – Transfer to a Minor Child
18 2001 External Technical Interpretation 2001-0098185 – Transfer of Life Insurance to Child
19 1995 External Technical Interpretation 9433865 – Disposition of Life Insurance Policy on Death
20 1996 External Technical Interpretation 9618075 – Transfer of a Life Insurance Policy to a Child
21 1999 External Technical Interpretation 9831355 F - Life insurance policy transfer (originally in French)
22 1993 External T.I. 9327305 F
23 1993 External T.I. 9327305 F, 2003-0004275 and 2013-0481421C6
24 2017 External Technical interpretation 2016-0671731E5 F (originally in French) and 2017-0690331C6
25 2006 External Technical Interpretation 2006-0197211C6 F (originally in French) “Round Table - Taxation of Financial Strategies and Instruments”
26 1999 External T.I. 9826715
27 2012 External Technical Interpretation 2011-0391781E5
28 1999 External Technical Interpretation 9908430
29 Income Tax Folio S4-F7-C1, Amalgamations of Canadian Corporations
30 2005 External Technical Interpretation 2005-0116631C6 “Round Table – life insurance policy of subsidiary; winding-up