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TRANSFER OF OWNERSHIP OF A LIFE INSURANCE POLICY INVOLVING A CORPORATION

Reference document

iA Financial Group

Transferring ownership of a life insurance policy is a subject which can raise many questions and cause major consequences for policyholders. More specifically, such a transfer can have impacts for the assignor, as well as for the assignee. The complexity surrounding the rules applicable to a transfer of ownership vary according to the characteristics of the life insurance transferred, the relationship between the parties to the transaction and even the nature of the transfer.

DEFINITION

To understand the rules surrounding the transfer of ownership of a life insurance policy, first we have to know exactly what constitutes a "transfer." In general, there is a transfer of ownership of a life insurance contract as soon as there is a change of policyholder (policyowner). For tax purposes, the transfer of ownership of a life insurance policy corresponds to the "disposition of an interest in an insurance contract." Subsection 148(9) of the *Income Tax Act* (ITA) states that with respect to "the interest in a life insurance policy", the term "disposition" includes:

- A surrender of the policy,
- A policy loan,
- The dissolution of that interest by virtue of the maturity of the policy, and
- A disposition of that interest by operation of law only.

In other words, when the policyholder disposes of the benefits granted to him or her by a contract one way or another, there is disposition of an "interest in a life insurance policy" for tax purposes, and this disposition can lead to consequences. Hence, the simple fact of requiring a change of policyholder through the transmission of a form for this purpose to the insurer constitutes a disposition.

It may be noted in passing that the definition in subsection 148(9) is not exhaustive. Any transaction that significantly modifies the conditions of application of a life insurance contract can lead to a disposition. Essentially, it must be determined if, based on all the facts, the modifications made are important to the point where it can be concluded that the original contract is replaced by a new contract. It is recommended that policyholders consult their legal advisor to help them determine if such modifications constitute a disposition for tax purposes.

General rule

ARM'S LENGTH TRANSFER OF PROPERTY

In summary, three types of transfer can be considered: transfers which follow the general rule, exceptions to the general rule (rollover to the children, rollover to the spouse, etc.) and the specific rules which include a transfer through distribution, by way of gift, or transfers between people who do not deal at arm's length.

Contrary to its designation, the general rule is not the one that applies most frequently. This rule primarily addresses situations where the policyholder disposes of his or her interests in a life insurance policy, in favour of a person with whom they deal at arm's length, in consideration of a selling price. This is primarily a sale by private agreement. In this case, the selling price is negotiated between the parties and complies with the rules of an open market. Other than the rare cases of speculative selling, we can consider an employee who, when he or she leaves their job, receive an offer to become the holder of the insurance contract underwritten on their life which their employer purchased when they were hired. Since the employer no longer needs the contract, it can sell its rights in the contract to its former employee, for a price negotiated between them.

According to the general rule, when a policyholder disposes of his or her rights with respect to a life insurance contract, they must include in their income the difference between the selling price and its adjusted cost basis (ACB). The result of this calculation, if positive, is taxable for the policyholder. Therefore, the disposition of an insurance contract can generate a policy gain. This gain is taxable at 100% in the hands of the policyholder and does not have preferred tax treatment, which is the case for a capital gain. The ACB of the contract for the new policyholder corresponds to the amount that he or she paid for the contract.

As mentioned above, the general rule has limited use, particularly for companies. However, it could be possible for a corporation to acquire an insurance policy on the life of a shareholder or a key person with a person with whom it deals at arm's length. In these circumstances, the price paid for the contract is considered to correspond to its fair market value and the transferring entity must include the gain realized on the sale of the policy in its investment income.

Specific rules

TRANSFER OF OWNERSHIP BY WAY OF GIFT, DISTRIBUTION, OR NON-ARM'S LENGTH TRANSACTION

The specific rule applies if an interest in a life insurance policy is the subject of disposition by way of gift, through a distribution by a corporation or through any transaction in favour of a person with whom the holder does not deal at arm's length. In these cases, the policyholder is deemed to have received deemed proceeds of disposition, corresponding to the higher of the following three amounts: the surrender value of the policy, the value of the consideration received in exchange for the policy or the ACB of the policy. If applicable, the policyholder must include in his or her income the difference between the deemed proceeds of disposition and the policy's ACB.

Moreover, the assignee's ACB will correspond to the deemed proceeds of disposition of the assigning policyholder.

Arm's length

The concept of arm's length is used for several purposes by the ITA. According to the provisions of section 251, related persons do not deal at arm's length. Therefore, people connected by a blood relationship, marriage or common-law partnership or adoption are deemed not to deal with each other at arm's length.

When the time comes to apply this rule to corporations, it should be noted that a company is related to the shareholders that control it and to the persons who are related to these shareholders.

Furthermore, summarily, two corporations are related to each other if one controls the other or if they are controlled by the same person, or the same group of people.

Finally, to determine if two unrelated persons deal at arm's length at a given moment, we must analyze all the facts surrounding their situation. For example, two people who, at first glance, deal at arm's length could be deemed not to deal at arm's length if they act together, in a common interest.

Transfer of ownership of a shareholder to a corporation

In accordance with what is stated above, there is deemed disposition when a shareholder transfers an interest that he or she holds in a life insurance policy to a company with whom he or she is not at arm's length. This is the case where a shareholder, who personally holds a life insurance policy, now wants their corporation to be the holder and beneficiary of this policy.

There was a time when the transfer of ownership of a policy by a shareholder in favour of a company with which he or she was not dealing at arm's length could be very profitable. Therefore, when the fair market value (FMV) of the policy was higher than its surrender value, it was possible to extract surpluses from the company in a fiscally beneficial way. The March 2016 Federal Budget modified the ITA to end this benefit. Since then, when transferring ownership, the shareholder is deemed to have disposed of the life insurance policy for deemed proceeds of disposition, corresponding to the higher of the following three amounts: the surrender value of his or her interest in the policy, the fair market value of the consideration received when transferring ownership, or the policy's ACB. The shareholder will be taxed on the difference between the deemed proceeds of disposition, as determined in accordance with the above rule, and the policy's ACB. This is fully taxable investment income (it is not a capital gain).

Note that there is no impact for the transferee corporation. Under the ITA, the ACB will be deemed to correspond to the shareholder's deemed proceeds of disposition.

ACB = Adjusted cost basis
SV = Surrender value
PD = Proceeds of disposition
FMV = Fair market value
ITA = Income Tax Act

Example

Life insurance policy held personally

Face amount	ACB	SV
$1,000,000	$100,000	$250,000

The policy is transferred by the shareholder, to a company in which he or she is the only shareholder (non-arm's length transfer).

Scenario 1
Transfer without consideration

Deemed PD = the higher of:

SV
$250,000

Market value of the consideration received
$0

ACB
$100,000

- Deemed PD = $250,000
- Taxable income
  Deemed PD – ACB = $250,000 – $100,000 = $150,000
- The shareholder will have to include $150,000 in his or her income because of the transfer.

ACB of the policy for the transferee corporation
$250,000

Scenario 2
Transfer in consideration of an amount of $300,000

Deemed PD = the higher of:

SV
$250,000

Market value of the consideration received
$300,000

ACB
$100,000

- Deemed PD = $300,000
- Taxable income
  Deemed PD – ACB = $300,000 – $100,000 = $200,000
- The shareholder will have to include $200,000 in his or her income because of the transfer.

ACB of the policy for the transferee corporation
$300,000

We understand that, to prevent the shareholder from being penalized by the applicable rules, the amount of the consideration paid on the transfer should generally be set at a value corresponding to the higher of the surrender value and the ACB, without exceeding the policy's FMV. If not, the shareholder will be obligated to pay taxes on an amount that he or she did not receive.

Transfer of ownership of a corporation to a shareholder (individual or corporation)

The transfer of ownership of a life insurance policy to a shareholder can be processed differently according to whether the assigning shareholder is an individual or a corporation. In all cases, for this type of transaction, it is important to consider the effects of the transfer from both the assignor and the assignee's point of view.

Transfer of ownership by a company, to a shareholder who is an individual

The situations where the transfer is made to an individual are attributable to a withdrawal from business by a shareholder or a key employee. Whereas the company was originally the policyholder of an insurance contract on the life of a shareholder or a key employee, an event can occur which results in the protection no longer being useful or necessary for the company's purposes. These situations occur when a shareholder disposes of the shares that he or she holds in the share capital of the company or when an employee terminates his or her employment with the company. In some of these cases, the individual wants to keep the life insurance policy for personal reasons. If applicable, there are generally two possible options: the gift of the policy or an assignment in exchange for a consideration payable by the assignee.

The transfer of ownership to a shareholder or key employee with whom the company does not deal at arm's length is subject to the application of the provisions of subsection 148(7) of the ITA. The same applies to situations where the transfer is made without consideration, as well as during the distribution by a company. In other words, when a company transfers the ownership of an insurance policy in favour of a person with whom it does not deal at arm's length, or when the transfer is made by way of gift or by way of a dividend payable in kind, it is deemed to have disposed of its interest in the policy, for proceeds of disposition corresponding to the higher of the following three amounts: the surrender value, the market value of the consideration that it received or the policy's ACB.

Moreover, we also have to take into account the consequences that the transfer could have on the assignee. If the assignee did not pay the fair consideration in exchange for ownership of the life insurance policy, he or she will have to include a taxable benefit in his or her income (benefit taxable to the shareholder under subsection 15(1) of the ITA or the benefit to the employee under paragraph 6(1) a) of the ITA). This benefit corresponds to the difference between the fair market value of the life insurance policy and the amount paid by the assignee. It is important to note that this taxable benefit is generally not the subject of any tax slip. It is therefore the assignee's responsibility to have the FMV of the life insurance policy established by a qualified and independent appraiser and to self-assess the value of the benefit received.

Example 1

Life insurance policy held by a corporation (Face amount on the life of one of the shareholders = $2M)

Face amount	SV
$2,000,000	$750,000
ACB of the policy	**FMV established by an appraiser**
$500,000	$1,000,000

As part of the sale of shares that he or she holds in the company's share capital, the shareholder wants to keep the insurance policy on his or her life. Therefore, the policy is assigned to the shareholder by way of gift.

Scenario 1

Transfer without consideration (gift)

Deemed PD = the higher of:

SV

$750,000

Market value of the consideration received

$0

ACB

$500,000

- Deemed PD = $750,000
- Taxable income
  Deemed PD – ACB = $750,000- $500,000 = $250,000
- The company will have to include $250,000 in its income because of the transfer.

Moreover, the shareholder will have to include in his or income the following amount as a benefit to the shareholder:

- Taxable benefit to the shareholder
  FMV of the policy – amount paid in consideration
- Taxable benefit to the shareholder
  $1,000,000- $0 = $1,000,000

ACB of the policy for the shareholder

$1,000,000

Example 2

Life insurance policy held by a corporation (Face amount on the life of one of the employees = $500,000)

Face amount	SV
$500,000	$125,000
ACB of the policy	**FMV established by an appraiser**
$100,000	$250,000

When he retires, the father of the primary shareholder of a corporation wants to keep the insurance policy on his life. Therefore, the life insurance policy is assigned to him for a consideration corresponding to the surrender value ($125,000).

Scenario 2

Transfer for a consideration equal to the surrender value

Deemed PD = the higher of:

SV

$125,000

Market value of the consideration received

$125,000

ACB

$100,000

- Deemed PD = $125,000
- Taxable income
  Deemed PD – ACB = $125,000- $100,000 = $25,000
- The corporation will have to include $25,000 in its income, because of the transfer.

Moreover, the employee (father of the primary shareholder) will have to include in his income the following amount as an employee benefit:

Taxable benefit

FMV of the policy – amount paid in consideration

$250,000- $125,000 = $125,000

ACB of the policy for the father of the primary shareholder (new retiree)

$250,000

Transfer of ownership by a company, to a shareholder that is a corporation

The processing of the transfer of ownership remains essentially the same when the shareholder is also a corporation. This is the case when an operating company transfers the interest that it holds in a life insurance policy to a holding company that holds its shares (parent company).

During a transfer of ownership of an insurance policy by a corporation to a shareholder company, the rules applicable to the ceding company remain the same. Hence, the ceding company is deemed to dispose of its interest in the policy for proceeds of disposition equal to the higher of the following three amounts: the surrender value, the fair market value of the consideration that it received or the ACB of the policy. The company will have to include in its income an amount corresponding to the difference between the deemed proceeds of disposition and its ACB.

Moreover, the transfer can be made through the payment of a dividend in kind to the transferee corporation. If applicable, it is therefore possible to reduce or eliminate the taxable benefit for the transferee corporation. To transfer by way of dividend, the FMV of the policy must be determined. As mentioned above, you should call upon a qualified independent appraiser. Once the FMV is determined, the ceding company can declare a dividend for an amount corresponding to this value to the transferee corporation. This dividend is paid in kind, by transferring the policy to the shareholder company. Subject to the conditions of subsection 112(1) of the ITA, the dividend paid between the two companies is not taxable.

It is important to note that the payment of a dividend between two companies can be subject to the application of the provisions on "safe income" outlined in subsection 55(2) of the ITA. Under these rules, a non-taxable intercorporate dividend could be recharacterized as a taxable capital gain. Considering its adverse impact, it is essential to make sure that the transaction is excluded from the application of subsection 55(2) ITA. It is strongly recommended that you consult a tax specialist competent in this area before paying the dividend.

Example

Transfer by way of distribution (intercorporate dividend, paid in kind)

HOLDCO holds 100% of the shares of OPCO

Policyholder: OPCO

Face amount	SV
$2,500,000	$500,000
ACB of the policy	FMV established by an appraiser
$150,000	$1,500,000

OPCO transfers ownership of the life insurance policy to its parent company, HOLDCO.

The transfer is made by declaring a dividend whose payment is made in kind.

The company's tax specialist is consulted in order to ensure that the rules are respected so that the dividend is deductible for HOLDCO and that it meets the safe income requirements in subsection 55(2) of the ITA.

Tax treatment for OPCO

Deemed PD = the higher of:

SV
$500,000

Market value of the consideration received
$0

ACB
$150,000

- Deemed PD = $500,000
- Taxable income
  Deemed PD – ACB = $500,000- $150,000 = $350,000
- OPCO will have to include $350,000 in its income, because of the transfer.

Tax treatment for HOLDCO

Deemed amount of dividend
$1,500,000

Taxable amount of the dividend for HOLDCO
$0

ACB of the policy for HOLDOC
$500,000

Transfer of ownership between two companies whose shares are held by the same shareholder (sister companies)

The shareholder of several corporations can find himself in a situation where he has to transfer an insurance policy from one of his companies to another. In this type of situation, the rules mentioned above apply. Therefore, the ceding company is deemed to dispose of its interest in the insurance policy for deemed proceeds of disposition, determined in accordance with subsection 148(7) of the ITA.

Example

The shares of Company A and Company B are held by a single shareholder.

Company A holds an insurance policy that it must transfer to Company B.

Face amount $1,000,000	SV $100,000
ACB $50,000	FMV determined by an appraiser $125,000

Scenario 1
Transfer without consideration ($0)

Deemed PD = the higher of:

SV
$100,000

Market value of the consideration received
$0

ACB
$50,000

- Deemed PD = $100,000
- Taxable income
  Deemed PD – ACB = $100,000- $50,000 = $50,000
- Company A will have to include $50,000 in its income, because of the transfer.
- Taxable benefit to the shareholder: the benefit to the shareholder could reach $125,000 (see comment below)

ACB for Company B
$100,000

Scenario 2
Transfer in consideration of an amount corresponding to the FMV = $125,000

Deemed PD = the higher of:

SV
$100,000

Market value of the consideration received
$125,000

ACB
$50,000

- Deemed PD = $100,000
- Taxable income
  Deemed PD – ACB = $125,000- $50,000 = $75,000
- Company A will have to include $75,000 in its income, because of the transfer.
- Taxable benefit to the shareholder: the benefit to the shareholder could reach $125,000 (see comment below)

ACB for Company B
$125,000

According to the position adopted by the Canada Revenue Agency, when the consideration paid by the transferee corporation is lower than the policy's FMV, it could result in a taxable benefit for the shareholder (see scenario 1 and scenario 2). This is the case to the extent where, following the transfer, the ceding company has become impoverished, and it is demonstrated that the shareholder benefitted personally from it. If applicable, the shareholder must include in his income a taxable benefit corresponding to the difference between the FMV of the policy and the consideration paid to the transferee corporation.

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