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Corporate Retirement Strategy: What is a guarantee fee and how do you value it?

When you borrow money you usually have to give the lender some collateral. If you don't repay the loan the lender can use your collateral to get back at least some of what you owe. Shareholders who own all or most of the shares in their own private corporations have an additional option. They can borrow personally, but have their corporations provide the collateral. There can be good reasons for doing this. The shareholder may not personally own any assets that are suitable as collateral, or may not want to limit their ability to deal with a personally-owned asset by pledging it as collateral.

Our "Corporate Retirement Strategy" concept provides an illustration of a shareholder using a corporate-owned life insurance policy as collateral for a loan the shareholder personally takes. This article considers some of the tax issues surrounding a corporate guarantee for a shareholder's personal loan.

Is a benefit conferred by a corporate loan guarantee?

The Canada Revenue Agency (CRA) maintains that when a private corporation pledges its assets to secure a shareholder's loan the corporation is conferring a benefit on the shareholder.[1] Dealing with the case of a wholly-owned subsidiary that had provided a loan guarantee for its parent corporation, the CRA said:

> [N]o person dealing at arm's length with another person would act as guarantor to a loan of that other person unless he received valuable consideration for the risk involved. Consequently, in our view, a benefit may be conferred on the parent notwithstanding that the subsidiary has not given up its beneficial ownership of any of its property.[2]

In a different case, the CRA said, "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."[3]

[1] CRA Document 2000-0002575, dated March 29, 2000.
[2] CRA Document 9206835, dated March 18, 1992.
[3] CRA Document 2006-0174011C6, dated June 29, 2006.

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Taken together, these cases suggest that the CRA regards a corporate loan guarantee for a shareholder's personal loan as something of value. Unless the shareholder pays for that guarantee (by paying a fee, for example) the CRA will treat the shareholder as having received a shareholder benefit.

How is the shareholder benefit valued?

The CRA has considered what an acceptable value for a loan guarantee would be:

> The value of a benefit arising from the right to use someone else's property as security for a loan is a question of fact. One method of calculating the fair market value of such a right might be to compare the difference between the interest rates charged with and without the corporation's collateral security. Another method might be to determine what the shareholder would have to pay a third party to provide a similar collateral security.[4]

In separate guidance the CRA reiterated its view that an acceptable value for a loan guarantee would be the difference between the interest rate that the lender would charge with the corporate-owned life insurance policy as security and the rate that the lender would charge without it.[5]

Valuing the guarantee with reference to differing interest rates can work well if the interest rate is the only difference between a loan with or without a corporate loan guarantee. It could become complicated if the difference was something other than the interest rate. For example, if the lender were willing to charge the same interest rate, but lend more money, or allow a longer time for repayment, valuing the guarantee fee could become more complicated.

Commentators in the financial services industry have also made suggestions about an appropriate value for the guarantee fee. One is that a reasonable guarantee fee is between 1 – 2% of the outstanding loan balance.[6] Another is between 1 – 1.5%.[7]

The fee could be adjusted for the risk that the corporation is assuming. For example, a shareholder with a decades-long stellar credit rating, wanting to borrow for a short period of time, could expect to pay a fee at the low end of the range, because of the low risk that the corporation would ever have to honour its guarantee. But a guarantee fee for a shareholder just emerging from their second bankruptcy, and wanting to borrow for a long period of time, could be at the high end, reflecting a higher risk of default.

Choosing one approach over another ultimately requires the parties to consider what the CRA would think was reasonable. That means that clients should consult with their tax professionals on how to proceed when they are borrowing money personally, but using corporate assets as security.

The amount of the guarantee fee is determined and taken into account each year that the loan is outstanding. If the loan balance varies from year to year, the guarantee fee that the shareholder pays will also vary. Specifically, the Corporate Retirement Strategy concept contemplates an increasing loan balance as the shareholder borrows money each year, spends that money, borrows again, capitalizes the interest on the outstanding loan balance, and never pays back any of the borrowed money. Repayment of the loan principal and accumulated interest occurs at the shareholder's death. As a result, the guarantee fee should rise throughout the shareholder's life as the amount of the corporation's collateral supporting the loan increases.

Accounting for the guarantee fee

Depending on the circumstances, the shareholder may want to treat the corporate loan guarantee as a taxable shareholder benefit rather than pay a guarantee fee. There are a couple of reasons for this. First, the corporation may have to treat any guarantee fee that it receives from the shareholder as income. In a case where a shareholder guaranteed a wholly-owned corporation's loan, and the corporation paid a guarantee fee

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[4] CRA Document 2000-0002575, dated March 29, 2000.
[5] Question 24 from the 1991 Canadian Tax Foundation Revenue Canada Round Table.
[6] Tax Planning Regarding the Ownership of Life Insurance, Peter Everett and Chris Ireland, PPI Financial Group, 2004-10-01
[7] Glenn R. Stephens, Estate Planning with Life Insurance, 4th edition, 2008, page 171.

to the shareholder, the CRA said that the shareholder had to treat the guarantee fee as income.[8] While this is the reverse of the situation discussed in this article, it is still possible that the CRA would adopt the same position regarding a corporation guaranteeing a shareholder's loan.

Second, any money that the shareholder pays to the corporation is money that could not come back to the shareholder without tax consequences, either as income, a shareholder benefit, or as a dividend.

If, however, the shareholder treats the corporation's guarantee as a shareholder benefit, and includes the value of that benefit in income, the corporation will not receive any payment for the guarantee, and will not need to add that payment to its own income. Later, there will be less money in the corporation to be taxed upon removal at some future date. Again, clients will need to speak with their tax professionals on how best to deal with the shareholder benefit that a corporate loan guarantee represents.

What if the lender has to realize on its security?

What if a shareholder defaults on the loan? If the corporation has pledged some of its assets to secure the loan, the corporation could forfeit some or all of what it has pledged. Whatever the corporation loses because of the shareholder's default (minus what it can recover from the shareholder) is an additional shareholder benefit:

> In the situation where the corporation is called upon to honour the Guarantee, any payments that the corporation makes to the financial institution to fully discharge its obligation under the Guarantee, including the security realized by the financial institution, would generally constitute a benefit conferred on the shareholder under subsection 15(1). However, any amounts that the corporation recovered from the shareholder will reduce the benefit.[9]

What happens at the shareholder's death?

At the shareholder's death, the loan comes due and the corporation becomes entitled to receive the life insurance policy death benefit. While it would be tempting to have the corporation pay off the loan using the death benefit, that approach won't work for two reasons. First, in order for the corporation to claim the death benefit the financial institution would have to release its security interest. But it won't be able to do that unless the loan is paid off. Second, even if the parties were able to resolve that difficulty, the corporation's payment of a shareholder's loan would be treated as a taxable shareholder benefit.

Fortunately, there's a different approach:

- The shareholder's estate, as the new shareholder, provides substitute collateral to the financial institution.
- The financial institution releases its security interest in the life insurance policy.
- The corporation then claims the death benefit.
- That part of the death benefit exceeding the policy's adjusted cost basis may be posted to the corporation's capital dividend account. Capital dividends may be paid to shareholders tax-free.
- The corporation pays a capital dividend to the shareholder's estate.
- The shareholder's estate uses the capital dividend to pay off the loan.
- The financial institution releases its security interest in the estate's collateral.

This approach applies when the shareholder has borrowed money personally, but has had their corporation guarantee the loan. A different approach may be used when the corporation has borrowed the money. See our "Corporate Retirement Strategy Advisor Guide" for more details, and be sure to have the client's executor discuss the loan repayment with their tax advisor.

[8] CRA Document 2005-0116281E5, dated May 5, 2005.
[9] CRA Document 9206835, dated March 18, 1992.

Advising clients

The Corporate Retirement Strategy shows how a client can borrow money using a corporate-owned life insurance policy as collateral. How the client deals with the shareholder benefit that results from the corporate guarantee is an important part of the discussion the shareholder must have with their tax advisors.

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