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FAIR MARKET VALUE OF CORPORATE SHARES AND LIFE INSURANCE

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The Income Tax Act (ITA) provides in subsection 70(5.3) that in the event of the death of a shareholder of a corporation, only the cash surrender value (CSV) of any insurance policy on the shareholder's life needs to be considered for purposes of determining the fair market value (FMV) of the deceased's shares in order to calculate the capital gain or loss on the shares. This means that even if the FMV of the life insurance policy was very high immediately before the insured's death (because, for example, he or she had a terminal illness), only the CSV of the policy would be taken into account for the valuation of shares. In some cases the difference between a policy's CSV (which is nil in the case of term insurance) and its FMV can be quite substantial. Nonetheless, there are certain factors to keep in mind when it comes to this provision of the ITA.

The Challenge

It's important to note that this presumption applies only in respect of the policy on the deceased shareholder and any other insured persons not dealing at arm's length with the deceased immediately before his or her death or at the time the policy was issued. In a family context where all shareholders are non-arm's length with the deceased, there will generally not be any particular problems, as subsection 70(5.3) ITA will allow all life insurance policies to be valued according to their CSV and not their FMV.

However, if the corporation is the beneficiary of a policy on the life of a key employee who is not a shareholder, and is at arm's length with the deceased, valuation of the deceased's shares will be based on the FMV of the policy under which the key employee is insured. This could create problems if the FMV of the policy is substantially higher than its CSV.

In a much more common scenario, three shareholders who are all at arm's length might each own one third of the shares of XYZ. Inc. and XYZ inc. would be the owner and beneficiary of individual insurance policies (for $1 million each, let's say) on the life of each shareholder. If Shareholder A, for example, develops a serious health condition, the value of the shares owned by Shareholders B and C could increase significantly in the event one of those two dies. As a result, if Shareholder B were to die, the tax authorities could claim that the shares of the deceased (Mr. B) were

worth substantially more for the purposes of share valuation, due to the high FMV of the policy on the life of Shareholder A, who is still living but is in poor health.

Possible solutions

If there is a shareholders' agreement among the parties concerned, it could allow the FMV of the deceased's shares to be determined with reference to a specific provision in the agreement. If there is no shareholders' agreement, and if a valid agreement is not put in place to address potential issues around the FMV of shares, an alternative solution will have to be found.

One possible option is a multi-life insurance policy. This means there will be a single policy, but the policy benefit will be payable on the death of each insured person.

In cases where there are two shareholders dealing at arm's length, consideration could also be given to having a single policy covering the lives of both shareholders, but with the policy benefit payable on the first death only, to enable the surviving shareholder to buy the deceased's shares from his or her estate. In both of these scenarios, as there is only one policy (even though it covers multiple lives), subsection 70(5.3) ITA would apply to consider only the cash surrender value of the policy for purposes of valuation of the shares at death.

This solution is, however, not perfect. In fact, a multi-life insurance policy has only one adjusted cost basis (ACB). Consequently, when one of the persons insured under the policy dies, the full amount of the ACB will be subtracted from the insurance proceeds received by the corporation for purposes of the credit to the capital dividend account (CDA). This means that the corporation's CDA may not be maximized. Lastly, a specific ACB calculation is also applied to multi-life insurance policies under which the value of the fund is paid on the death of the first insured person or on the death of each of the insured persons.

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