Life's brighter under the sun

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Life Insurance Shares

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It is quite common for corporations to own insurance policies on the lives of their shareholders. In certain situations, it may be desirable to have the death benefit from a policy directed to a specific individual. In that context, the articles of the corporation could provide for a special class of shares that will make it possible to direct the life insurance proceeds to that person. This class of shares is commonly referred to as “life insurance shares.” Life insurance shares are used primarily in the case of a shareholder's departure, or to ensure family and estate equalization, or simply to attribute the cash surrender value of a life insurance policy to a specific class of shares.

This guide explains the characteristics of life insurance shares and the main situations in which they can be used. The guide also addresses the tax and non-tax issues that may arise from the use of this class of shares.

Characteristics of life insurance shares

Like other classes of shares, life insurance shares can be specified in a company’s articles of incorporation. If life insurance shares are not already included in the articles of incorporation, the articles will have to be amended to add life insurance shares as a new class of preferred shares.

Generally, life insurance shares have the following rights and restrictions.

Voting Rights

Life insurance shares do not carry voting rights. They are not intended to interfere with the decision-making power of the company but rather to channel insurance proceeds to specific individuals.

Participation

Except for the dividend to which life insurance shares may give rise, the holder of the life insurance share does not participate in the profits or surplus assets of the corporation.

Dividends

Life insurance shares entitle the holders of such shares, in priority to the corporation's other classes of shares, to a dividend equal to the death benefit of any life insurance policy taken out on the life of a shareholder. It is important to note that the dividends declared and paid out of this death benefit come from the Capital Dividend Account ("CDA").

Cash surrender value and life insurance shares

Some permanent life insurance products may have a cash surrender value (CSV). Whole Life and Universal Life policies in particular are policies that have a cash surrender value. Depending on the features of the policy, the cash surrender value will have an impact on the death benefit that is paid out. For Universal Life (UL) policies, the CSV is generally added to the benefit paid at death. In the case of a participating whole life insurance policy with a CSV, the CSV is generally not added to the death benefit.

Participating whole life insurance consists of base coverage that provides a level death benefit plus additional coverage in the form of paid-up additions (PUA), if this option is selected. Because a whole life policy has specific features, drafting an agreement that includes life insurance shares can be more complex with this type of life insurance.

Purposes of life insurance shares

One of the main purposes of using life insurance shares is to ensure estate equalization among members of a family business. For example, life insurance shares can provide family members who are not involved in the business with financial compensation derived from the life insurance proceeds.

Life insurance shares can be especially useful in an estate freeze where one or more children do not wish to be involved in the business. Accordingly, life insurance shares can be issued to these children to ensure estate equalization. Life insurance shares can also be issued to a family trust that names the children not involved in the business as beneficiaries.

When there is no estate freeze, issuing life insurance shares to the shareholder allows the proceeds of the corporate-held life insurance to flow to the person who owns the life insurance shares. Through a will, the deceased shareholder can thus transfer the life insurance shares to the children not involved in the business and the common shares to the children involved in the business.

It's also possible to pay capital dividends from the proceeds of the corporate-owned life insurance to the children not involved in the business. They would receive the death benefit (less the policy's ACB, if any) via non-taxable capital dividends.

In addition to estate equalization, life insurance shares can be also be used in the case of a shareholder's departure or in a share redemption agreement.

How life insurance shares are set up

Life insurance shares are set up by reorganizing the capital stock of a corporation according to the provisions of section 86 of the Income Tax Act (ITA).[1] This reorganization is usually done by creating a new class of shares before the company purchases the life insurance policy. As there is no life insurance policy in force at that point, the life insurance shares would be low in value.[2] Since the value would be expected to remain fairly low for some time, the life insurance shares can be issued for a minimal sum.[3]

Life insurance shares also serve to isolate insurance proceeds by using a separate class of shares. This allows the death benefit to be channelled to an individual, a group of individuals or a family trust, depending on the situation. For share redemptions, life insurance shares can also be used to avoid adverse tax consequences to the fair market value of the shares sold to the non-arm's length survivor.

In summary, life insurance shares are an efficient way for a corporation to direct the death benefit that it receives. The death benefit can then be distributed to equalize estate assets. Life insurance shares allow the death benefit to flow to specific beneficiaries by means of non-taxable capital dividends.

[1] If the life insurance shares are not already included in the articles.
[2] See section below on the tax considerations of life insurance shares.
[3] Usually issued for a nominal value of $1.

Practical example

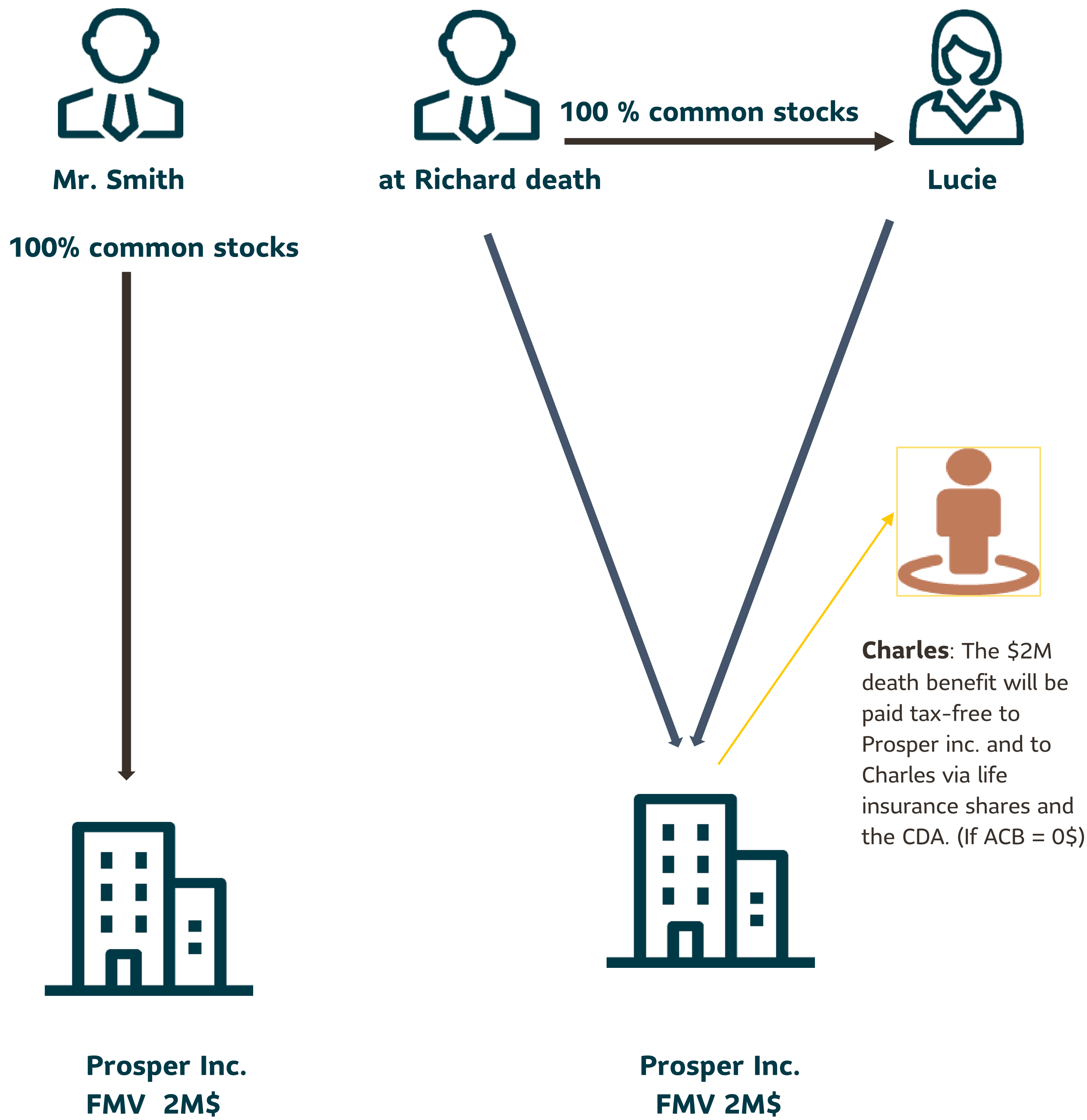
Let's look at the following example to see how life insurance shares work.

Mr. Charles Smith is the sole shareholder of Prosper Inc. Prosper Inc. has a fair market value (FMV) of $2 million. Mr. Smith is consulting a professional about optimizing his estate plan where his main goal is to ensure fair treatment for both his son and his new spouse at the time of his death. Mr. Smith would like to accomplish this by gifting the common shares of Prosper Inc. to his spouse Lucie (who is not the mother of his son). He would also like to leave a life insurance policy to his son Charles, which is equal to the value of Prosper Inc. ($2 million).

Prosper Inc. would purchase the policy because a corporately owned policy has the advantages of paying for the policy with lower after-tax dollars and the possibility of taking advantage of the capital dividend account [CDA] mechanism where dividends can be paid out on a tax-free basis.). Mr. Smith designates his son as the beneficiary of the policy. However, this approach may result in a taxable benefit pursuant to subsection 15(1) of the Income Tax Act (ITA).

There may be a more tax favourable option with the use of life insurance shares. Under this strategy, the capital of Prosper Inc. would be reorganized under subsection 86 ITA before the corporation purchases the life insurance policy. New shares would be issued which would be non-voting, non-participating, and redeemable at the corporation's option. Since there is no life insurance policy in place yet, the life insurance shares would have a nominal value of only $1. Mr. Smith's son would then purchase the shares, entitling him to receive a non-taxable capital dividend equal to the policy's $2 million death benefit, to the extent of the CDA credit arising from the life insurance policy.

Thus, the son's purchase of the life insurance shares and the gift of the common shares to the spouse would achieve Mr. Smith's goal of estate equalization, but in a much more tax-efficient manner.



Mr. Smith’s situation is an example of a blended family scenario where a shareholder would like to leave something to an adult child from a previous relationship, while still gifting the shares in the corporation to his or her spouse who is not the child's parent. To achieve the goal of estate equalization, the shareholder’s child could purchase life insurance shares.

SHAREHOLDER AGREEMENTS AND LIFE INSURANCE SHARES

In some situations, when a corporation receives the proceeds of an insurance policy on the life of one of its shareholders, it may not be necessary to use life insurance shares to achieve shareholder objectives. As well, the shareholder agreement usually stipulates that the share value will not take into account any insurance proceeds received by the corporation on the life of a shareholder. Depending on the circumstances, the shareholder agreement will stipulate:

a) the purchase or redemption of the deceased shareholder's shares by the corporation itself, in which case the corporation will use the death benefit to pay the shares to the estate to give the estate the benefit of the corporation's CDA generated by the deceased shareholder's death benefit;
b) the distribution of the insurance proceeds to the surviving shareholders by means of the CDA after they have purchased the deceased shareholder's shares. This ensures that the surviving shareholders do not have to share the CDA with the deceased shareholder or their estate and can use all of the funds to pay the purchase price of the deceased shareholder's shares.

TAX CONSIDERATIONS OF USING LIFE INSURANCE SHARES

The use of life insurance shares raises two tax questions:

- What is the fair market value (FMV) of a life insurance share?
- Is there a taxable benefit to the holder of life insurance shares given that the company pays premiums on an insurance policy that will benefit the holder of those life insurance shares?

The fair market value of life insurance shares

The FMV of life insurance shares is certainly a major taxation issue. The general comments in *Information Circular IC89-316* deal with how the FMV of a private corporation's shares are determined. More specifically, the FMV of life insurance shares was discussed at the Association de planification fiscale et financière ("APFF") Conferences in 2005 and 2008.

At the 2005 APFF Conference, the Canada Revenue Agency ("CRA") was presented with a case where a sole shareholder of a corporation wished to bequeath his common shares to his spouse, but wished to have the proceeds of the insurance policy taken out on his life by the corporation paid to his adult child.[4] To achieve these objectives, the following transactions were proposed:

- Creation of a class of non-voting life insurance shares, with the holder entitled to a dividend equal to the proceeds of the insurance policy taken out by the corporation on the life of the sole shareholder (such dividend being declared only on the death of the sole shareholder), which entitles the holder, in the event of redemption of such shares, to a redemption price equal to the cash surrender value of the insurance policy taken out on the life of the sole shareholder of the corporation, if such redemption of the life insurance shares takes place during the lifetime of the sole shareholder, or to the insurance proceeds (less any dividends previously declared from such proceeds) if such redemption takes place after the death of the sole shareholder. The holder of the life insurance shares is entitled to the cash surrender value, whether it is a redemption at the corporation's option, a redemption at the holder's option or a distribution in the event of liquidation or dissolution of the corporation.

[4] CRA's position described in document 2005-0138111C6

- The adult child acquires a life insurance share for $1.

- The corporation underwrites the insurance policy. At the time the policy is purchased, the policy's cash surrender value is nil, given the applicable surrender charges.

The CRA was asked the following question: Can the CRA confirm that immediately before the taxpayer's death, the **cash surrender value** of the policy will not increase the FMV of the common shares held by the sole shareholder, since this value is reflected in the redemption price of the insurance share held by the owner's adult child, all pursuant to subsection 70(5.3) ITA?

In its response, the CRA said the following:

- Subsection 70(5.3) of the ITA deems that the fair market value of a life insurance policy is equal to the cash surrender value of the policy immediately before the particular individual's death.

- The wording of subsection 70(5.3) of the ITA does not specify how to distribute the cash surrender value of the life insurance policy among the various classes of shares.

- In general, the CRA is of the opinion that it would be reasonable to distribute the insurance policy's cash surrender value among the various classes of shares based on the rights and conditions attached to them, in the same way as the overall value of a firm would be allocated among the various classes of shares in circulation.

- In this scenario, the class of life insurance shares issued to the adult child is redeemable at the holder's option immediately before the insured's death, for an amount equivalent to the cash surrender value of the said policy.

- Also, based on the facts provided in this case, it would not be unreasonable to allocate, immediately before the death, the amount of the policy's cash surrender value to the life insurance shares.

- As a result, the value of the common shares held by the sole shareholder in this scenario would not reflect the cash surrender value of the insurance policy on the life of shareholder. It appears that efforts to draft the rights and restrictions of "one-way" life insurance shares are yielding results and that the value of the insurance policy taken out by the corporation on the life of its shareholder can be fully channelled into the life insurance share class created for that purpose.

As a result of CRA's response on the valuation of the common shares of the corporation (which value would not take into account the cash surrender value of the policy on the life of the shareholder), it must be concluded that the value of the insurance policy would be allocated to the life insurance share.

In 2021, the CRA confirmed its position described in document 2005-0138111C6 regarding the allocation of the cash surrender value (CSV) of a life insurance policy for the purpose of determining the fair market value of property (shares) deemed to have been disposed as a consequence of death in accordance with subsection 70(5.3).[5]

Fair market value at time of issue or at time of death

Also at the 2005 APFF Conference, the CRA addressed the FMV that could be allocated to life insurance shares at the time of issue or at the time of the shareholder's death.[6]

Unlike the previous situation, this question was about a class of non-voting, non-participating life insurance shares redeemable at $1 at the corporation's option. The sole benefit of this class of life insurance was to entitle the shareholder(s) to receive a

[5] 2021 CLHIA Roundtable - Q4 - Life insurance shares - CRA document 2021-0884291C6 (E)

[6] CRA document no. 2005-0138361C6

capital dividend equal to the death benefit received by the corporation upon the death of the insured shareholder. The only other class of shares issued by the corporation are common shares held 100% by the sole shareholder.

Two situations were raised in this question:

Situation A

- An adult child acquires a life insurance share for $1;
- Subsequently, the corporation underwrites a temporary 100-year insurance contract (with no cash surrender value) on the shareholder's life;
- The corporation is the policyholder, pays the premiums and is the contract beneficiary.

Question for the CRA

Can the CRA confirm that the FMV of this share is $1 at time of issue?

CRA’s response

With respect to the FMV of a life insurance share at the time of issue, CRA did not express an opinion and reiterated certain general principles:

- the FMV of a share must be determined in accordance with recognized valuation methods and must take into account all the relevant factors related to the share; the CRA does not advocate an exclusive valuation method;
- the CRA now agrees to examine requests from taxpayers concerning review of complex valuation-related topics;
- the CRA does not express an opinion on the value of a property or on the estimates or statements which a taxpayer proposes. In principle, the FMV of such a life insurance share issued for $1 and redeemable at that same amount should have a value of $1 given that the redemption price of the life insurance share does not include the cash surrender value of the life insurance policy. Finally, since the policy underwritten by the corporation had no cash surrender value, this would not have changed our assessment of the FMV of the life insurance share in question.

Situation B

- The sole shareholder buys a life insurance share for $1;
- Subsequently, the corporation underwrites an insurance contract on the shareholder's life, which may this time have a cash surrender value;
- The corporation is the policyholder, pays the premiums and is the beneficiary;
- At the time of his death, the shareholder holds all of the common shares and the life insurance share;
- At this point, moreover, the insurance contract has cash surrender value.

Question for the CRA

Can the CRA state if, for the purposes of calculating deemed capital gain immediately after the death under subsection 70(5.3) of the ITA, the cash surrender value of the insurance contract will be taken into account in evaluating the market value of the common shares or the life insurance share?

CRA’s response

The CRA began with general principles in this case as well:

- the wording of subsection 70(5.3) ITA does not specify how to distribute the cash surrender value of the life insurance policy among the various classes of the corporation’s shares;

- generally, the CRA is of the opinion that it would be reasonable to distribute the cash surrender value of a life insurance policy between the different categories of shares based on the rights and conditions attached to them, in the same way as the overall value of a business is distributed between the different categories of shares in circulation.

The CRA then stated:

- it appears that the overall value of the corporation that would be attributed to the life insurance share immediately before the death would be nominal;

- accordingly, the value of the common shares immediately before the death would take into account almost the entire cash surrender value of the life insurance policy.

In **Situation B**, contrary to **Situation A**, the insurance policy has a cash surrender value that must be taken into account for the purposes of subsection 70(5.3) ITA. On the other hand, as in **Situation A**, the life insurance share is acquired for $1 in **Situation B**. This share is redeemable for $1 at the corporation's option without taking into account the policy's cash surrender value.

In summary, the context under consideration in **Situations A** and **B** is that of a category of life insurance shares that is not allocated the policy's cash surrender value but that is allocated the life insurance proceeds.

In 2021, the CRA stated that the comments provided at the APFF 2005 Conference, described above, continue to apply to that identical fact situation.[7]

However, CRA added that the purpose of this question was to obtain the CRA's views on whether in applying subsection 70(5.3), immediately before the taxpayer's death, the cash surrender value of the life insurance policy would be taken into account in determining the fair market value of the common shares or the fair market value of the special/insurance share and our comments at that time were limited to this narrow aspect of the question.

Consequently, and given that the facts outlined in this question only summarize very briefly a hypothetical situation, the above comments should not, in any manner, be interpreted as being applicable to other tax consequences that may arise in a given situation and should not be construed as implying that the CRA has confirmed, reviewed or made any determination in respect of any other tax consequences that may arise in a given situation.

At the 2008 APFF Conference, the CRA again addressed the FMV of a life insurance share upon the death of its holder.[8] This time, the question was about which category

[7] 2021 CLHIA Roundtable - Q5 - Life insurance shares CRA 2021-0884301C6 (E)

[8] CRA document 2008-0286151C6, 10 October 2008

of share (again, common shares or life insurance share) should take into account the proceeds of the life insurance policy.

The CRA was asked the following question:

- A taxpayer is the sole shareholder of a corporation.
- The corporation wants to subscribe to a term insurance policy (without cash surrender value) on the life of its shareholder.
- The corporation will be the policyholder and beneficiary. The taxpayer wants the proceeds of this life insurance to benefit someone other than the person who will inherit his common shares.
- The corporation creates a class of life insurance shares that are non-voting, non-participating, redeemable at the option of the holder before death, at its issue price of $1 and, after death, at its issue price plus the proceeds of the life insurance policy.
- Subsequently, the shareholder acquires one special share for $1.
- At the time of his death, the taxpayer holds all the common shares and the life insurance share.

Can the CRA confirm that immediately before the taxpayer's death, the FMV of the life insurance share, for the purposes of subsection 70(5) ITA, will be equal to its issue value of $1 and will not take into account the **value of the life insurance proceeds** payable at death, since subsection 70(5.3) of the ITA specifies that only the cash surrender value of the policy subscribed on the life of the deceased shareholder is to be considered in the valuation of his shares?

CRA’s Response

The CRA’s response was similar to its response to Situation A in the question posed at the 2005 APFF Conference. In other words, the CRA simply repeated the general principles on valuing a share. Among its comments were the following:

- The CRA does not advocate an exclusive valuation method.

- CRA does not have its own method for computing the FMV; this computation is based upon the facts known on the valuation date, to which the principles and standards of the Canadian Institute of Chartered Business Valuators (CICBV) are applied. The CRA now agrees to examine requests from taxpayers concerning complex valuation issues.
- Subsection 70(5.3) of the ITA gives some details for valuing an asset such as the life insurance policy but does not specify how to value the various classes of shares.

The only specific element in the CRA's response is the following line: "For this reason, CRA cannot definitively conclude that the fair market value of the special share will always be the issue price."

Therefore, in the CRA's view, a life insurance share, except in specific situations, would be valued at its issue price until the date of death of the shareholder whose life is insured and who owns the life insurance share.

Taxable benefits and life insurance shares

It is accepted that premium payments for an insurance policy taken out by a corporation on the life of a shareholder[9] are not considered a benefit to the insured shareholder if the corporation is the owner and beneficiary of the policy.[10] However, the CRA has not expressed a specific position on the question of the insurance proceeds received by the beneficiary corporation that are directed to a specific person.[11]

In an interpretation from 2005,[12] the CRA stated that provided that the issue price of $1 reflects the fair market value of the life insurance share at the time of issuance, it is the CRA's view that subsection 15(1) ITA will not apply to include a benefit in the child's income as a consequence of the child acquiring the special share. The life insurance share described in this interpretation was a non-voting share redeemable at the option of the corporation for $1 per share, with dividends equal only to the amount added to the CDA out of the proceeds received by the corporation from the life insurance policy upon the death of its sole shareholder.

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[9] Subsection 15(1) ITA.

[10] See Technical Interpretations 2006-0178561E5, 3 November 2006; 2007-0257251E5, 19 November 2009; 2011-0407291C6, 7 October 2011; 2011-0413281C6, 7 October 2011.

[11] The concept of "indirect" benefit has not been addressed by the CRA to date.

[12] See Technical Interpretation no. 2005-0116621C6, "Capital dividend streaming – insurance proceeds," 26 May 2005.

To prevent a life insurance share from being valued at more than its subscription price, the share should normally be purchased **before** the corporation purchases the insurance policy from which the share will derive proceeds.

Life insurance shares: Possible Tax and Non-Tax Issues

Death of the life insurance share holder

If the holder of the life insurance share dies before the insured shareholder, there may be tax consequences. First, the impact will depend on the FMV assigned to the life insurance share immediately prior to the death of the holder. Thus, if this FMV results in a capital gain, the estate of the deceased would be required to pay tax.

One way to avoid capital gains tax is to allow the share to pass to the holder's spouse.

Another solution is to have a discretionary family trust purchase the life insurance share. This way, if the sole shareholder of a corporation is also the trustee of the trust and the trust arrangement grants the trustee power of appointment, the sole shareholder will have considerable latitude in dividing the proceeds of the corporate-owned life insurance policy among the beneficiaries, without these proceeds having to pass through the estate.

It may also be specified that in the event of the premature death of the holder of the life insurance share that rights for that class of share shall be automatically redeemable by the corporation upon the death of the holder for a redemption price equal to the amount paid into the capital stock account issued and paid for such shares when they were subscribed.
Of course, this assumes that redemption when the holder dies does not defeat the purpose for which the life insurance share was purchased in the first place.

Life insurance shares and income splitting rules

Under the new Tax On Split Income (TOSI) rules,[13] it would be assumed that the LI Shares refer to shares of a private corporation issued to non-active shareholders who are relatives to an active (or formerly active) shareholder and tracks the life insurance in the corporation on the active (or formerly active) shareholder's life. It would then be assumed that there are other related shareholders at the time of the dividend (and after the death) that would cause the TOSI rules to apply.

The TOSI rules do not apply to capital dividends. It is assumed that most of the value of the LI Shares relates to the capital dividend account that will be paid on these shares. While taxable dividends may be subject to TOSI, an exception may be available under the reasonability rules, but no comments with respect to life insurance have been provided on these rules by the Department of Finance or the CRA.

Thus, in summary, no TOSI risk exists where a capital dividend is paid. If the share is sold (other than on death), the gain may be subject to TOSI if it is not a QSBC share.

A shareholder's agreement designating the payout of the CDA on the LI Shares is essential and would be used to ensure that the applicable proceeds are paid on the preferred LI shares. Without this type of agreement, taxable dividends could be paid on the life insurance shares and TOSI could apply. This situation can occur after the death of the common shares shareholder if the common shares are transferred to a beneficiary who wants to keep the CDA versus paying it to the LI shares shareholder.

Matrimonial concerns and life insurance shares

It is unclear how a family law court would view a life insurance share held by a spouse at the time of marriage breakdown. Life insurance shares related to a policy with low or no cash surrender value will probably be a safer solution if the goal is to manage the possibility of a relationship breakdown.

[13] Section 120.4 ITA

Other factors to consider

The viability of using life insurance shares depends first and foremost on the corporation's ability to keep the life insurance policy in force for an extended period of time. The corporation must therefore ensure it has the financial means to pay the required premiums before such a strategy is put in place. It should be noted that the death benefit paid to the corporation may be subject to claims by the corporation's creditors, if any.

While the CRA appears to take a favourable view of life insurance shares, it has never expressed a clear position on the FMV it would assign to these shares at the time of issue or whether the holder of such shares would incur any taxable benefit. Finally, although unlikely, the CRA may choose to apply the General Anti-Avoidance Rule (GAAR) to a particular strategy.

Conclusion

Life insurance shares can be very useful for channelling proceeds from a corporate-owned life insurance policy to a specific individual, or for attributing the cash surrender value of a policy to a specific class of shares. Considering the potential impacts, always consult experts in this area before using life insurance shares as a strategy.

Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of their tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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