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COMMENT

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The Valuation of Corporate-owned Life Insurance on the Death of a Shareholder

The valuation of life insurance policies for the purposes of Canadian tax law is subject to a confusing set of rules and interpretations. In some instances, specific provisions in the *Income Tax Act* (the Act) apply, and in others, more general provisions may or may not apply. Regardless, these rules are subject to the interpretation of the Canada Revenue Agency (CRA), whose pronouncements can be inconsistent and difficult to reconcile.

Let's focus on the rules that apply where a private corporation owns a policy on the life of a deceased shareholder. In this case, subsection 70(5.3) of the Act provides relatively clear rules. Predictably, there are circumstances that fall outside of the specific wording of this provision and which should be identified.

1. General Application of Subsection 70(5.3) on a Shareholder's Death

Section 70 of the Act contains a lengthy list of provisions dealing with a taxpayer's death. In the case of capital property, such as shares of a private corporation, a disposition is deemed to occur immediately before the shareholder's death. To the extent that the shares' fair market value (FMV) at that time exceeds their adjusted cost base (ACB), a capital gain will be recognized in the deceased's terminal return. Similarly, a capital loss will be realized where the shares' ACB is greater than FMV.

As readers will be aware, the above is subject to exceptions that apply where shares are transferred to a surviving spouse or common-law partner, or to a qualifying trust for such person. In that case there is a "rollover" that defers the realization of any capital gain or loss to the death of the surviving spouse or partner.

Subsection 70(5.3) specifically deals with the valuation of shares deemed to have been disposed of on death, where the corporation owned insurance on the life of the deceased or on the life of an individual with whom the deceased did not deal at arm's length at the time the policy was issued (such as the deceased's spouse, sibling, or child). Where the subsection applies, the FMV of the shares will be determined as though the FMV of the relevant policy was its cash surrender value (CSV). For these purposes, policy loans are essentially ignored, and are therefore included in the CSV. Unpaid dividends and the CSV of paid-up additions are also included.

These rules were introduced following the 1977 Federal Court of Appeal decision in the case of *Mastronardi v. The Queen*. In that case, the taxpayer successfully challenged the CRA's position that the death benefit under a corporate-owned term insurance policy should be considered in valuing the deceased's shares.
The Court held that no insurance proceeds were payable "immediately before death," and that as a result the amount of the proceeds should not be considered in valuing the deceased's shares under the deemed disposition rules. Subsection 70(5.3) essentially codifies the *Mastronardi* decision, although with certain limitations that will be addressed below.

2. Technical and Planning Considerations

a) Limitations on the Scope of Subsection 70(5.3)

As described above, subsection 70(5.3) applies to policies on the life of the deceased and certain non-arm's length parties. It does not, however, apply in a number of other circumstances. Let's look at three examples where the subsection would not apply:

Example 1

Assume that A is the sole shareholder of a corporation that owns insurance on A's life. The corporation also owns a "key person" policy on B, a person who is a key employee but not a shareholder, and with whom A deals at arm's length. On A's death, subsection 70(5.3) will apply in valuing the policy on A's life. It will not, however, apply in determining the value of the policy on B's life. Therefore, the FMV of A's shares immediately before death will include the CSV (if any) of the policy on A's life, but the policy on B's life, as it impacts the value of A's shares, will be valued under general valuation principles (see discussion in Example 3).

Example 2

The inclusion of insurance on the life of non-arm's length parties within subsection 70(5.3) applies only where that relationship existed at the time the policy on the deceased's life was issued. There could be (admittedly rare) circumstances where there was an arm's length relationship when the policy was issued, but the parties became non-arm's length at a later date. For example, if A and B in the above example were originally arm's length parties, but were married after the policy on A's life was issued, subsection 70(5.3) would still not apply in valuing the policy on B's life at the time of A's death. (Any resulting increase in A's share value would not be of concern, however, if A's shares were transferred to B on a tax-deferred basis following A's death.)

Example 3

Assume that three arm's length shareholders, X, Y, and Z, are equal shareholders of a corporation. The corporation acquired insurance on all three lives for the purposes of buy-sell funding. Assuming X was the first to die, subsection 70(5.3) would theoretically apply regarding the corporate-owned policy on his life, but not regarding the policies on his arm's length co-shareholders, Y and Z. This may, however, be simply an academic point, as the valuation formula under the shareholders agreement would likely override subsection 70(5.3), i.e., the FMV of the deceased's shares would be based upon a binding agreement that, in most cases, should specifically exclude life insurance proceeds from the purchase price.

b) Valuation where 70(5.3) Does Not Apply

Where subsection 70(5.3) does not apply, an insurance policy would be valued on general valuation principles. These would presumably apply in valuing the policy on B's life, at the time of A's death, in Example 1. The valuation would likely require the services of an independent actuary. The CRA's views on the valuation of life insurance policies are provided in Information Circular IC 89-3 and would be important in any valuation performed by an independent actuary. The key factors identified in the circular are as follows:

- the CSV of the policy;
- the loan value of the policy;
- the face value of the policy;
- the state of health of the life insured and his or her life expectancy;
- the policy's conversion privileges;
- replacement value; and
- the perceived imminence of death.

c) CRA Commentary on Shared Ownership

Under a typical shared ownership agreement, ownership of a life insurance policy is shared between one party who requires the life insurance coverage (typically a corporation) and another who has longer term needs (typically the shareholder). The costs and benefits of the policy are shared by the parties in accordance with a shared ownership agreement. Generally, the death benefit owner (the corporation) will pay an amount reflecting insurance charges under the policy, and will designate a beneficiary for the policy's face amount. Deposits to the policy's investment accounts will be made by the cash value owner (the shareholder), who will designate a beneficiary for that portion of the policy.

In a recent roundtable presented by the Conference for Advanced Life Underwriting, the CRA was asked to comment on the potential application of subsection 70(5.3) in a shared ownership arrangement. The question concerned whether the policy's CSV would be included in the value of shares owned by a deceased shareholder where, under the shared ownership arrangement, the CSV had been owned by the deceased.

In its response, the CRA noted that subsection 70(5.3) does not specifically refer to policies where there is more than one ownership interest, and was unable to state definitively that the value of the corporation's interest would be nil. It appears that the CRA is concerned about certain situations where the corporation is "quick paying" premiums and, as a consequence, benefiting or subsidizing the shareholder. In its response, the CRA stated that "the terms and conditions of the shared ownership arrangement, the specific life insurance contract and all other related agreements which may form part of the particular arrangement and the particular facts at the given time would have to be considered. …"

It is hoped that the corporation's interest in the policy will be valued at nil for the purposes of subsection 70(5.3), in an arrangement where the corporation's share of the premiums more accurately reflects the actual annual cost of insurance, and does not benefit the shareholder in any way. In this regard, shared ownership arrangements will be considered on a case-by-case basis and need to be structured carefully. ©

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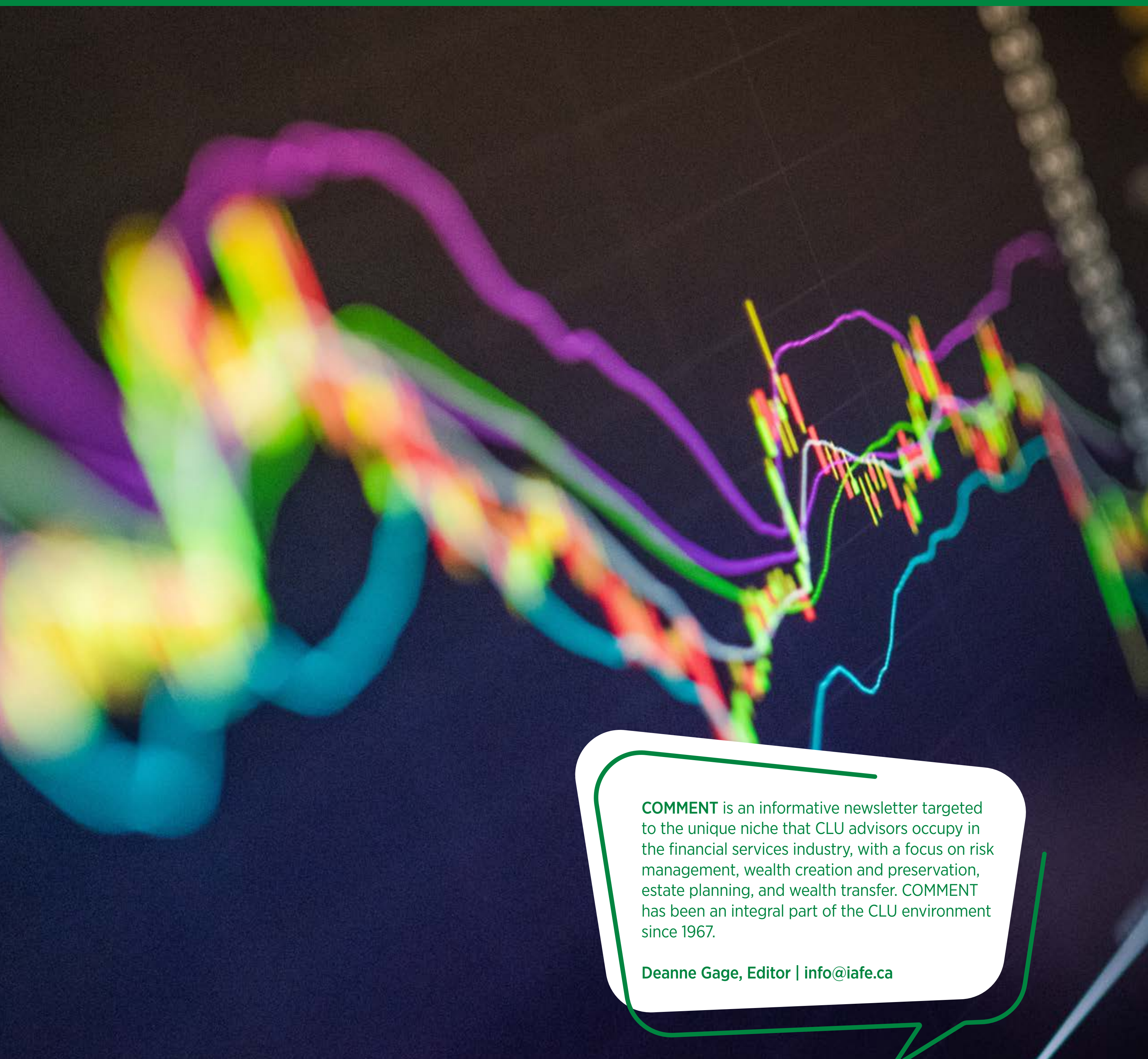

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