COMMENT

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A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

Leveraged Insurance Annuities and the CRA

When the Canada Revenue Agency (CRA) is concerned about the promotion of particular arrangements as having tax benefits, they may issue a warning to the public. That is what the CRA did with respect to leveraged insurance annuity (LIA) products on August 26, 2020. However, this is not the first time concerns regarding LIAs have come to light. Indeed, the CRA has been concerned about LIAs for 25 years.[1] Previous concerns led to legislative changes in 2013, and by 2016 there were indications that new structures of concern were being developed.[2] While the amendments were intended to restrict the tax benefits from these products, the CRA remains concerned that structures that may escape the rules in a technical sense are still being promoted, especially by offshore entities.

Characteristics of LIA Plans of Concern

The basic structure of a leveraged insurance annuity is a loan that is secured by a life insurance policy and annuity. One of the legislative changes made in 2013 involved adding a definition of a "LIA policy" to the *Income Tax Act* (ITA).[3] That definition is written in relation to the life insurance policy component but refers to the loan and annuity elements as well. It requires that a person or partnership become obligated to repay an amount at a time based on the death of a person whose life is insured under the policy. It also requires that the lender is assigned an interest in the policy and an annuity that provides payments during the life of the person whose life is insured. The definition applies to situations where the obligation to repay arose after March 20, 2013.

The other elements of the legislative amendments from 2013 are framed with reference to this definition of an LIA. Those provisions will be discussed further in this article. While it is not explicitly stated, the implication of the warning given in the CRA's 2020 notice is that they are actively reviewing situations where the LIA does not technically fit within the definition in the ITA.

The CRA's 2020 notice describes the "schemes" of concern. The description is in some ways more specific than the legislative definition of an LIA policy. In the schemes of concern, the loan would typically be limited recourse or no risk and from an offshore lender. The loan would also be conditional on acquiring the life insurance and an annuity to pay the premiums on the life insurance contract. In the scenarios of particular concern, the "so-called insurer" would likely be offshore as well. The principal and interest would also be capitalized and paid out of the death benefit. Another characteristic the CRA identified is that the life insurance contract and annuity would actually be assigned to the offshore lender to repay the limited recourse loan on death. The CRA emphasized that "the life insurance policy, the annuity and the loan are heavily interdependent, would not have been issued on a stand-alone basis and do not make commercial sense from the perspective of the purchaser, the provider or the individual being insured if the intent of the policy is in-fact insurance."

Previous CRA comments from 2016 also refer to the idea of the terms of the various products, such as the price being manipulated, and that the life insurance

policy portion of the arrangement may even be on a non-insurable life.[4] Those concerns likely remain valid.

CRA Warning

The CRA's 2020 notice is strongly worded and indicates significant concern in this area. A portion under the heading "Your actions may have serious consequences" reads as follows:

> *Through increased audits of promoters, improved intelligence gathering and strengthened communication with taxpayers, the CRA continues to identify and shut down tax schemes.*
>
> *The CRA reviews leveraged insurance products, including LIAs, to determine whether they are valid insurance products or just vehicles for a tax advantage. The CRA has also identified LIAs where the general anti-avoidance rule (GAAR) will be used to deny the tax benefit sought.*
>
> *In the event the CRA finds these purported insurance products to be invalid, participants, and those who promote and sell them, face serious consequences. The Canada Revenue Agency (CRA) is warning Canadians about getting involved in tax schemes involving leveraged insured annuity plans. Promoters, including tax representatives and tax preparers, are claiming that taxpayers can extract tax-free earnings from corporations or claim large insurance expenses using a leveraged insured annuity provided by supposed offshore insurers.*

The CRA is clear that they are challenging the validity of arrangements that they consider schemes in order to deny the purported tax benefits. The reference to serious consequences for promoters suggests this includes imposing third-party penalties.[5]

The language of "supposed offshore insurers" also indicates there are schemes where the CRA has taken the view that, in addition to not involving a valid life insurance policy, the entity behind them is not even a valid insurer.

Purported Benefits

The CRA pointed to several tax benefits that promoters behind these schemes claim they will provide. The specific examples of purported benefits that are mentioned in the CRA notice are relevant in situations where it is a private corporation that takes out the loan and is the beneficiary under the life insurance policy. These benefits are: a possible increase in the capital dividend account (CDA) of a private Canadian corporation and a deduction for the premiums and interest. A key part of the CRA's concern is these plans are being used to distribute corporate earnings without tax as loan repayments or capital dividends. The increase to a capital dividend account is a concern because the death benefit is used to repay the loan, so no value is truly added to the capital dividend account.

Consequences of Being an LIA Policy under the ITA

In addition to the definition of an LIA policy discussed above, the 2013 amendments to the ITA added a series of consequences for life insurance policies that meet the definition. The ITA contains provisions that typically allow for a deduction from business income for the lesser of the premium or net cost of pure insurance for life insurance that is used as collateral in certain circumstances. LIA policies are excluded from that deduction.[6]

A life insurance policy that is an LIA policy is excluded from being an "exempt policy."[7] This means that LIA policyholders are required to report the accrued income from the LIA annually.[8]

Another change was with respect to the annuity portion of an LIA on death. Typically, the payments under the annuity would stop on death.[9] As such, the annuity arguably had no value for the purposes of the deemed disposition on death. That is no longer the case. The ITA now provides that an annuity meeting the definition of an LIA is valued at the total of premiums paid for the purposes of the deemed disposition.[10]

One of the CRA's concerns is a CDA inclusion in situations where the life insurance death benefit is used to repay the loan. To address this, an LIA policy is excluded from the capital dividend account inclusion for life insurance proceeds.[11]

Interaction between Legislative Provisions and CRA Concerns

The 2013 legislative amendments address concerns that are quite similar to the issues raised in the CRA's 2020 notice. The fact that the warning was necessary suggests that the schemes of concern are designed to avoid the provisions of the ITA. For instance, the CRA's 2020 notice specifically mentions the capital dividend account inclusion, which has been disallowed for life insurance policies that fall within the statutory definition of an ILA policy. It is possible that further legislative amendments will be forthcoming to close some of these apparent loopholes. In the meantime, the CRA has indicated that it is applying the General Anti-avoidance Rule (GAAR).[12] That

provision allows the CRA to challenge situations that technically comply with the provisions of the ITA when there is a tax benefit resulting from a misuse or abuse of the provisions of the ITA or its regulations. Advisors should exercise extreme caution with any arrangement that appears to be an LIA in light of the CRA's warning "about getting involved in tax schemes involving leveraged insured annuity plans." ©

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[1] *CRA Views, Conference, 2016-0632601C6 – 2016 CALU CRA roundtable Q1—LIA policies*

[2] Ibid.

[3] *Subsection 248(1) "LIA Policy"*

[4] *CRA Views, Conference, 2016-0632601C6 – 2016 CALU CRA roundtable Q1—LIA policies*

[5] *Section 163.2.*

[6] *Paragraph 20(1)(e.2)*

[7] *Regulation 306(1)*

[8] *Subsection 12.2(1)*

[9] *Peter Everett, "Life Insurance Planning After the 2013 Budget," in* Report of Proceedings of the Sixty-Fifth Tax Conference, *2013 Conference Report (Toronto: Canadian Tax Foundation, 2014), 32:1-23. https://taxfind.ca/#/document/2013_cr_paper_32*

[10] *Subsection 70(5.31)*

[11] *Subparagraph 89(1)"capital dividend account"(d)(ii)*

[12] *Section 245*

The Importance of Share Valuation in Shareholder Agreements

One of the most important functions of a shareholder agreement is to set out the rules governing the transfer of shares amongst the shareholders. For example, most such agreements will have “triggering events” — such as a shareholder’s death or disability — which may cause a mandatory or optional purchase and sale of shares at a price that would be determined pursuant to the terms of the agreement.

Let’s review some of the key considerations in dealing with share valuations under a shareholders agreement. This will not provide suggestions on specific methodologies for valuing shares, which is an area that should be addressed by professional valuators, but will instead consider how to approach valuation from a legal and practical standpoint.

Potential Approaches to Valuation

In most cases when dealing with the death or disability of a shareholder, the purchase price for that person’s shares should be their fair market value. This is the price to which a willing buyer and a willing seller, dealing in an unrestricted market, would agree.

The reference to “fair market value” is somewhat incongruous, as there is usually not a market for shares of private corporations. Having said that, this is the term that applies under the *Income Tax Act* (ITA) in many circumstances, including the determination of capital gains or losses on death (i.e., the deceased is typically deemed to have disposed of his or her shares for fair market value). Crucially, it’s also the amount at which non-arm’s length parties, such as siblings, parents, and children, are deemed to transact for income tax purposes. Failure to do so can result in negative tax implications.

The question then becomes: What procedures should be used in a shareholders agreement for determining the price for shares bought and sold on death or disability? The following are some common techniques:

Annual valuation

Some agreements call for an annual valuation by the shareholders within a certain time period after the completion of the annual financial statements. This method is acceptable as long as the parties fulfill their obligations to do the valuation annually, but experience suggests that they rarely do so. Any agreement providing for an annual valuation should provide a means of updating the value if, for example, the existing valuation is more than two years old.

If the value is updated as anticipated, whether by the shareholders themselves or otherwise, it is helpful to attach the most recent valuation as a separate schedule to the agreement. This allows the update to be made regularly without the need to reopen the agreement.

Formula

Some agreements call for the use of a formula, such as a multiple of earnings, which can be used on an ongoing basis as corporate revenues and other relevant factors change. This is a relatively simple and consistent approach, however there is a risk that a formula may become out of date as the circumstances of the business change.

Similar to what was suggested above, if a formula is to be used it would be beneficial to include it as a separate schedule so that an updated formula can be added if need be.

Valuation by the corporation’s accountant

Many agreements provide that, where the shareholders are unable to agree on a value, the issue will be referred to the corporation’s accountant for a binding determination. That may seem sensible in some respects, as the accountant may be the person who is the most knowledgeable about the corporation’s financial situation. However, this approach does not consider the conflict of interest faced by the accountant in circumstances where, for example, the estate of a deceased shareholder is negotiating a price with the surviving shareholders. On the one hand, the accountant would need to consider the position of the estate, whose interest would be to obtain as high a price as possible, and on the other hand, would be dealing with survivors

who would want to negotiate as low a price as possible. What is the accountant to do, particularly if they want to retain the surviving shareholders and the corporation as clients? Most accountants would likely prefer to stay clear of this responsibility.

Valuation by an independent appraiser

In many cases, the most attractive approach is for the agreement to provide that on a shareholder's death or disability, the parties will attempt to negotiate a price on their own. Failing that, provision can be made for the appointment of an independent appraiser. In some cases, a second appraiser is called for, with the two valuations being averaged to determine the price. This approach allows for the involvement of an expert, if need be, without the potential of putting the corporation's accountant in a conflict of interest.

Insurance-related Valuation Issues

Even in the absence of regular formal valuations, shareholders should monitor ongoing changes in value. In many cases it is the insurance advisor whose role is key in ensuring that shareholders stay current with their valuation, as this relates directly to the level of insurance that will be required to ensure adequate funding.

Shareholder agreements should contain a number of life insurance-related provisions where policies have been acquired for buy-sell purposes. The agreement will identify the policy owner, beneficiary, and premium payor. It should also contain detailed provisions regarding the use and application of the proceeds, and clearly set out how the capital dividend account should be utilized.

Beyond these basic provisions, some insurance-related terms and conditions that specifically relate to share valuation are often included. In this regard, here are some suggested do's and don'ts:

(i) Should the price be based upon the amount of insurance?

On occasion, the convenience of using life insurance as the buy-sell funding vehicle encourages drafters of the agreement to stipulate the purchase price for a deceased's shares as the value of any life insurance held on the deceased's life pursuant to the agreement. The basic rule should be that the purchase price determines the amount of the insurance, not the other way around. Otherwise, potential disasters may result. What happens, for example, if the insurance lapses or if the fair market value of the shares becomes much higher than the insurance coverage?

A variation of the above may be more worthy of consideration, however. Some agreements provide that the purchase price will equal the greater of fair market value and the amount of available life insurance proceeds. This can be beneficial where share values may have declined, due to economic conditions or other circumstances, to an amount lower than existing life insurance coverage. In this way, the estate of a shareholder who, for example, dies during a temporary economic downturn, is still able to benefit from the full amount of available insurance.

(ii) Exclusion of insurance proceeds from purchase price

In most other cases, life insurance proceeds are not included in determining the share price. On the contrary, shareholders agreements will typically state that life insurance proceeds should be excluded. When paid, the proceeds will at least be a temporary asset of the corporation, but there will typically be a corresponding obligation for the proceeds to be distributed as part of the buy-sell process. For this reason, they do not constitute a part of long-term corporate value and should not normally be considered in determining the purchase price.

(iii) Excess or deficiency of life insurance proceeds

The agreement should contemplate the possibility that on a shareholder's death there will be either an excess or a deficiency of insurance proceeds. In the former case, the agreement should stipulate which party (in many cases, the policy owner) is entitled to the excess proceeds. In the latter case, the agreement should provide that the insurance proceeds will represent the down payment for the shares, payable within a certain period after death. The balance of the purchase price would be represented by a promissory note payable on whatever terms may be provided in the shareholders agreement. It is typical to provide for payment over three to five years, with interest at an agreed upon or determinable rate, and to give the purchaser the ability to prepay any amounts owing without penalty. ©

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Guarding Beneficiary Designations

Most advisors are aware of the importance of beneficiary designations when assisting their clients with their financial and estate planning goals. Beneficiary designations can be used for registered accounts as well as insurance products, including segregated fund contracts. The benefits of beneficiary designations are well known; they have been used to bypass the estate, reduce estate administration and probate[1] fees, and get proceeds into the hands of beneficiaries quickly.

However, recent legal challenges raised in Canadian courts[2] could call into question that named beneficiaries under these designations may hold these proceeds on trust for the benefit of the deceased policyholder's estate. I'll provide a brief summary of some of the jurisprudence as well as tips to help protect your client's intentions.

Brief History of the Presumption of Resulting Trust

In *Pecore v Pecore*,[3] the Supreme Court of Canada dealt with the case of a parent adding an adult child to a bank account as a joint owner. The Court found that, generally, where there is a gratuitous transfer from one party to another, there is a presumption that the recipient holds those funds on a resulting trust for the benefit of the transferor (or their estate if they are deceased).[4] A different presumption applies for transfers from a parent to a minor child.[5] As well, for most provinces, gratuitous transfers between spouses will also be subject to the presumption of resulting trust.[6]

Where the presumption of resulting trust applies, the burden is on the transferee (in the Pecore case, the adult child) to provide evidence that the parent intended the

transfer to be a gift. The transferee needs to rebut this presumption on a balance of probabilities.

The evidence required to rebut the presumption of resulting trust will differ on a case-by-case basis. For the joint bank account in this case, the Court commented on some types of evidence that the transferee could use to prove the transferor's intention to gift the joint account proceeds to the adult child:

- evidence of the transferee parent's intention at or near the time that the transfer occurred;
- evidence after the transfer occurred;[7]
- bank documents (anything to demonstrate the transferor's intent on the bank forms);
- control and use of the funds in the joint account;[8]
- whether a power of attorney existed;[9] and
- tax treatment of the joint account.[10]

If the evidence is not sufficient to rebut the presumption of resulting trust, then the transferee will hold the joint account proceeds for the benefit of the deceased's estate, to be distributed in accordance with the deceased's will (or pursuant to provincial intestacy legislation if there is no valid will). This makes these proceeds subject to the probate process and applicable probate fees.

Presumption of Resulting Trust and Beneficiary Designations

The Pecore case dealt with the presumption of resulting trust for *inter vivos* transfers (i.e., bank accounts). But what about accounts with beneficiary designations that are intended to pass to the beneficiary on the owner's death? Recent jurisprudence in several provinces suggests that these accounts could also be subject to the presumption

of resulting trust in the event of a court challenge. This puts an additional burden on the transferee (the named beneficiary) to prove that the transferor (the deceased) intended to gift the proceeds of these accounts for the transferee's benefit alone.

In British Columbia, beneficiary designations with an adult as named beneficiary have been presumed to be held on resulting trust in favour of the deceased's estate,[11] which follows earlier Manitoba case law.[12] In Alberta, a 2015 Court of Queens Bench decision implied that the presumption of resulting trust applied to beneficiary designations,[13] while in Saskatchewan, the Court of Appeal ruled that the presumption of resulting trust does *not* apply to beneficiary designations.[14]

Most recently, in the Ontario case of *Calmusky v Calmusky*,[15] the Court applied the presumption of resulting trust not only to a joint bank account held by an adult child and his parent, but also to the beneficiary designation in favour of that child with respect to the parent's registered retirement income fund (RRIF) — not an insurance RRIF. For Ontario, this is a new expanded application of the principles in the Pecore case, which is in line with some of the other provinces mentioned above. Of particular concern is the Court's view that there is "*no principled basis for applying the presumption of resulting trust to the gratuitous transfer of bank accounts into joint names but not applying the same presumption to the RIF beneficiary designation.*"[16] While many estate practitioners disagree with this view, and industry organizations have already commenced lobbying efforts to push for legislation that specifies that the presumption of resulting trust doesn't apply to beneficiary designations, unless legislation changes to provide additional protection to these designations, or there is a ruling from the Supreme Court of Canada, the current approach taken by the courts is the one that needs to be planned for.

Remember that the presumption only deals with who has the burden of proof to show the transferor's/deceased's intention. If the presumption of resulting trust applies, the burden is on the named beneficiary to show that the proceeds were a gift for their own benefit and not meant for the estate.

Even though there is inconsistency on whether there is a presumption or not, Canadian courts always have the power to impose equitable remedies, such as resulting or constructive trusts, which could result in a beneficiary designation being held for the benefit of the deceased's estate and not the named beneficiary. Advisors should, therefore, be aware of possibility that beneficiary designations can be challenged in court, and help their clients to prepare for this possibility.

What Can Advisors Do to Help Protect Their Clients' Beneficiary Designations?

First, advisors must clearly explain the purpose of the beneficiary designation to their client/planholder and make sure that the client intends the proceeds to only benefit the named beneficiary. Additionally, advisors need to explain the tax consequences of a named beneficiary receiving the proceeds and the potential for the estate to bear the associated tax liability.

Second, advisors can recommend that the client prepare a letter of intent (LOI), at or near the time the beneficiary designation is completed, which spells out why they have made this designation and why they intend for the proceeds to go to this named beneficiary. Among other things, the LOI could specifically state that there is no intention to create a resulting trust and that the true beneficial interest in the proceeds is intended to pass to the named beneficiary outside of the estate. For additional protection, the LOI should be witnessed, ideally by two adults who should not be the named beneficiary or a spouse of that beneficiary. Further, these suggestions should be applied for *each* beneficiary designation and not generally for all beneficiary designations. Ideally, the LOI will also specify that the client has considered the tax liability stemming from the transfer that occurs on their death.[17]

As there are no hard and fast rules regarding LOIs and what they should look like, advisors should recommend that clients prepare any LOI with the assistance of legal counsel that has expertise in estate planning; otherwise, clients could trigger unintended consequences.[18] The importance of an LOI will be influenced by the risk associated with the designation. As an example, a designation that is in favour of only one child and potentially disinherits other children, or is a departure from the residual provisions of the policyholder's will, is likely going to have a higher risk of a court challenge and will require greater safeguards to protect.

Third, advisors can recommend that the client/planholder has simultaneous discussions with their family members and other estate beneficiaries about the existence and purpose of the beneficiary designation and the estate plan generally, as these discussions could be used as corroborating evidence of intention.

Finally, advisors' notes from the client meeting where the beneficiary is designated could also be used in a court proceeding as corroborating evidence of the client's intention. Advisors should prepare detailed notes of these meetings and include the reason for the client's designation as well as the parties that were present and involved in the discussion.

These steps are especially important as a beneficiary designation form itself may be insufficient to demonstrate the client/planholder's intention. In the Calmusky case, the Court did not consider the beneficiary designation form to be detailed enough to provide reliable evidence of the planholder's intent. Likewise, the financial representative's recollection of her meeting with the planholder was limited. If the financial representative had detailed notes, as well as a letter of intent, that may have provided sufficient corroborating evidence of the planholder's intent and rebutted the presumption of resulting trust.

The jurisprudence surrounding the application of the presumption of resulting trust to beneficiary designations is evolving and will likely be subject to further discussion by the courts going forward. Advisors can help prepare their clients for the potential of legal challenges to their designations and take steps to help mitigate the risk of their clients' intentions being challenged in court. ©

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[1] *The probate process and fees do not apply in Quebec. There is a verification process for non-notarial wills but not for notarial wills.*

[2] *Excluding Quebec, which is based on a civil law system.*

[3] Pecore v Pecore*, 2007 SCC 17.*

[4] Pecore*, at paras 23–24.*

[5] *The presumption of advancement, meaning that it is presumed that the transfer was a gift.*

[6] *Previously, the presumption of advancement applied to gratuitous transfers from husbands to their wives. However, due to changes over the last couple of decades to most provinces' matrimonial property legislation, this presumption has little to no effect in most circumstances.*

[7] *E.g., evidence from a lawyer drafting a will, after the joint account was opened, as to the parent's intent to provide the account proceeds exclusively to that child.*

[8] *E.g., was the child using funds in the joint account for their own benefit or only their parent's benefit?*

[9] *E.g., did the child have power of attorney authority over the parent's accounts in addition to joint ownership?*

[10] *E.g., did the child or parent report the annual taxes due on the account? Did the parent report a taxable disposition at the time of the transfer?*

[11] *See* Neufeld v Neufeld*, 2004 BCSC 25. Also, see* Rainsford v Gregoire*, 2008 BCSC 310,* Slade Estate (Re)*, 2017 BCSC 2354, and* Williams v Williams Estate*, 2018 BCSC 711.*

[12] *See* Dreger v Dreger*, [1994] 10 WWR 293 (Man CA).*

[13] *See* Morrison Estate (Re)*, 2015 ABQB 769.*

[14] *See* Nelson v Little Estate*, 2005 SKCA 120. The Court distinguished between joint accounts, where the presumption of resulting trust does apply, and beneficiary designations.*

[15] Calmusky v Calmusky*, 2020 ONSC 1506.*

[16] Ibid. *at para 56.*

[17] *For example, in the* Morrison Estate *case, the Court allowed a designated beneficiary to keep the proceeds of a RRIF but required that beneficiary to reimburse the estate for the tax liability incurred with respect to the RRIF disposition.*

[18] *Legal counsel can also help make sure that the LOI does not unintentionally revoke a beneficiary designation or isn't construed to be a beneficiary designation itself, which could cause further ambiguity and uncertainty.*

COMMENT is an informative newsletter targeted to the unique niche that CLU advisors occupy in the financial services industry, with a focus on risk management, wealth creation and preservation, estate planning, and wealth transfer. COMMENT has been an integral part of the CLU environment since 1967.

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