The Institute™ for Advanced Financial Education

COMMENT

Edition 322 - Mar/Apr 2021

Compliments of:

BYDAND WEALTH MANAGEMENT

Don Gordon
BSc, CFP, CLU, ChFC, TEP

250.881.7600 bydandwm.ca gfgdon@shaw.ca
3298 Tennyson Avenue Victoria BC V8Z 3P3

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

Corporate Wind-ups and Life Insurance

by Joel Campagna and Dianna Flannery

What happens when a corporation is dissolved while owning a life insurance policy?

Consider the following situation: Your client, who is in their late 70s, sold his business several years ago and was left with an investment holding company (Holdco) that held marketable securities and a life insurance policy. Over the years, the investment portfolio has been depleted to fund the client's retirement, and now all that is left in Holdco is an insurance policy. The policy was purchased 25 years ago, and is a minimum funded universal life policy with level costs of insurance (COI) but minimal cash surrender value (CSV). The client decides that they no longer want to pay professional fees to file corporate tax returns and they instruct their lawyer to dissolve Holdco. The dissolution of the corporation will result in the transfer of ownership of the life insurance policy. This transfer may have some significant tax and legal implications.

Tax Implications

When a corporation is dissolved or wound up, and all or substantially all of its assets are distributed to individual shareholders, subsection 88(2) of the *Income Tax Act* (ITA) generally applies. Where a life insurance policy is included as part of the property distributed from the corporation to the shareholder(s), two deeming provisions could be used to determine the proceeds of disposition of the policy to the corporation, and the value of the policy received by the shareholder.

Generally, when a life insurance policy is distributed from a corporation, the proceeds of the disposition (PD) are governed by subsection 148(7) of the ITA, which states that the PD are equal to the greater of:

- the value of the policy,
- the adjusted cost basis (ACB); and
- the fair market value (FMV) of the consideration given for the policy.

Value is defined as the amount that the policyholder would be entitled to receive if the policy were surrendered (essentially the cash surrender value of the policy net of policy loans). Where the PD exceeds the ACB of the policy, the corporation will have a policy gain.

Alternatively, where the corporation is being wound up pursuant to subsection 88(2) and the policy is distributed to the individual shareholder, subsection 69(5) of the ITA could also apply. Subsection 69(5) provides that on a wind-up, the corporation will be deemed to dispose of the property (i.e., the life insurance policy) at FMV, and the shareholder will be deemed to have acquired the property for FMV. This provision has a less favourable tax result to the corporation as it will likely result in a larger policy gain.

At the 2015 Canadian Life & Health Insurance Association Roundtable (2015-0573841C6) the Canada Revenue Agency (CRA) was asked which provision (subsection 148(7) or 69(5)) applies in respect of the distribution of an interest in a life insurance policy by a corporation to a shareholder on a subsection 88(2) wind-up of the corporation. CRA noted that when two provisions of the ITA conflict

with each other the general rule is that the more specific provision takes precedence over the more general provision. CRA's response remains unchanged from the 2005 CALU roundtable (2005-0116631C6), and CRA restated that:

"…there is no clear indication as to which of subsection 69(5) and subsection 148(7) is applicable to the distribution of an interest in a life insurance policy. While we would generally expect subsection 69(5) to take precedence over subsection 148(7) in such circumstances, this approach is subject to a review of the particular facts and circumstances of an actual case to ensure that it provides for a reasonable result."

As a result, when a life insurance policy is being transferred from a corporation to an individual shareholder as part of a subsection 88(2) wind-up, CRA has indicated subsection 69(5) of the ITA would likely apply to deem the corporation to receive proceeds equal to FMV, and to the extent that the FMV exceeds ACB, the corporation will have a taxable policy gain.

The wind-up and distribution of the life insurance policy will also result in a taxable dividend to the shareholder in an amount equal to the FMV of the life insurance policy. The ACB of the policy to the shareholder will be the FMV immediately before the winding up.

The FMV of a life insurance policy can be significantly greater than CSV. Even policies such as term insurance or minimum funded universal life products that have no CSV can have a significant FMV. It is a question of fact in each circumstance what the FMV of a policy is. The CRA has included the following factors as relevant in determining the FMV of a life insurance policy:

- the CSV of the policy;
- the policy's loan value;
- the face value of the policy;
- the state of health of the insured and their life expectancy;
- conversion privileges under the policy;
- other policy terms, such as term riders and double indemnity provisions; and
- the replacement value of the policy.

Going back to our client situation above, a 25-year-old universal life policy with level COI may have significant FMV even without a change in health of the insured. The replacement cost of that policy at attained age will be significantly more expensive than the locked-in COI rates. Therefore, based on CRA's commentary, the wind-up of Holdco may result in a significant policy gain in Holdco. The policy gain will be subject to tax at rates applicable to investment income. (e.g., 50.17% in Ontario).

What about the tax implications to the client? When property is transferred out of a corporation to an individual shareholder on the dissolution of the corporation, the ITA deems a dividend to arise. The amount of the dividend is equal to the FMV of the property distributed to the shareholder. In our example, the wind-up of Holdco will result in a dividend to the shareholder equal to the FMV of

the policy. Assuming the dividend is an ineligible dividend, the shareholder could pay tax at a top marginal rate of 47.78% (Ontario).

From both a tax and cash flow perspective, the client would likely have been better off keeping the corporation and continuing to pay the annual tax filing fees. The present value of the tax filing fees is likely significantly less than the present value of the tax bill!

Legal Considerations on Dissolution

As you can see, dissolving a corporation that holds a life insurance policy may lead to some tax surprises. What about the legal implications?

Before a dissolution (also known as a wind-up) of a corporation occurs, practical issues must be addressed when it comes to life insurance. Unfortunately, from time to time, a dissolution of a corporation occurs before the life insurance policy is transferred out of the corporation; when this occurs, there are consequences. Let's first consider the steps that should be taken to ensure the policy is properly transferred during the wind-up of the corporation.

Steps to Transfer

The formal transfer of any property owned by the corporation, including a life insurance policy, is a requirement under provincial business corporation legislation, and is part of the transactions of the wind-up. Ontario's *Business Corporations Act* sets out prescribed requirements for a dissolution to occur:

- a special resolution of the shareholders;
- consent of the shareholders;
- no debts or liabilities remain outstanding at the time of dissolution; and
- that the corporation has distributed its remaining property[1]

A transfer of ownership of the life insurance policy must occur before the dissolution. To effect legal transfer of the life insurance policy, a transfer of ownership form must be signed by an officer/director who is authorized to sign on behalf of the corporation. In most instances the transferee is the life insured and shareholder of the corporation, and the transferor is the corporation. When completed and signed, the transfer of ownership form must be filed with the insurance company to complete the legal transfer of the life insurance policy. Once the transfer occurs, a taxable event may occur as a result of the transfer.

Consequences in Not Transferring

It is important to understand what will occur if the formal steps to transfer the policy as set out above do not occur prior to dissolution. In the common law provinces, if a life insurance policy is not transferred BEFORE dissolution, the life insurance policy becomes an asset of the Crown. This is also the case in Quebec unless the corporation has a single shareholder. In that case, the policy would be owned by that single shareholder, and not the Crown, regardless of the dissolution.[2]

Depending upon the province, the Crown may consent to a transfer of property by confirming that it takes no interest in the policy. The appropriate Crown's office will vary from province to province. A review of the applicable provincial act and/or regulation will have to be done to determine what government office should be contacted to provide this consent. Most insurance companies would accept the consent of the Crown, and this would enable the transfer of ownership form to be signed by the former director/officer of the company. However administrative practices of insurance companies may vary, and therefore should be reviewed to ensure the Crown's consent is enough to allow the transfer.

Provincial Considerations

In some provinces, a consent to transfer property is not provided as a matter of course, and is at the discretion of the appropriate minister's office.[3] For instance, in Manitoba, the Minister of Justice takes possession, and as a result has the ability to ask for a fee payment prior to releasing the interest in the life insurance policy.[4] This becomes problematic when there is no value in the policy, such as the case with a term policy. The fee amount is tied to the value of the property held by the Crown. Extra steps may be needed by the former officer/director of the corporation to obtain the necessary consent and deal with the fee request.

Another alternative solution is to have the corporation reinstated or revived by the province. Once this occurs, the reinstated directors/officers can sign the transfer form, file it with the insurance company, and dissolve the corporation when the transfer has been legally completed. This alternative is more costly and complicated, and may not be available as an option in all provinces after a certain period time. For instance, in Alberta, a corporation cannot be revived five years after the dissolution has taken place.[5] Additional steps may therefore have to be taken by the former officer/director to determine how best to proceed with the Crown's office.

When the just-mentioned obstacles exist, it may be easier — where it makes sense from a cost, product type, and insurability perspective — to allow the policy to lapse and apply for new insurance.

Understanding these issues and doing a status check with clients where there are corporate-owned policies is essential in preventing the Crown from owning the asset on dissolution. The types of questions that should be asked include:

- Is the insurance in the right place?
- Is the company still a going concern?
- If not, when did the status of the company change?
- Is there any intention to sell the company?
- Will the corporation be dissolved in the near future?
- Has an event occurred that may lead to a dissolution of the corporation (e.g., disability)?

These questions may uncover that a transfer is imminent, and would at least afford the opportunity to deal with the corporate policy to ensure that it does not get left behind during the wind-up process.

Dissolving or winding up a corporation that owns a life insurance policy can have some significant tax and legal implications, and should not be undertaken without receiving both tax and legal advice. ©

Written by Joel Campagna, CPA, CMA, CFP, TEP, assistant vice-president, regional tax and estate planning, individual insurance at Manulife Financial, and Dianna Flannery, J.D., TEP, senior consultant, tax, retirement and estate planning services, insurance, at Manulife Financial.

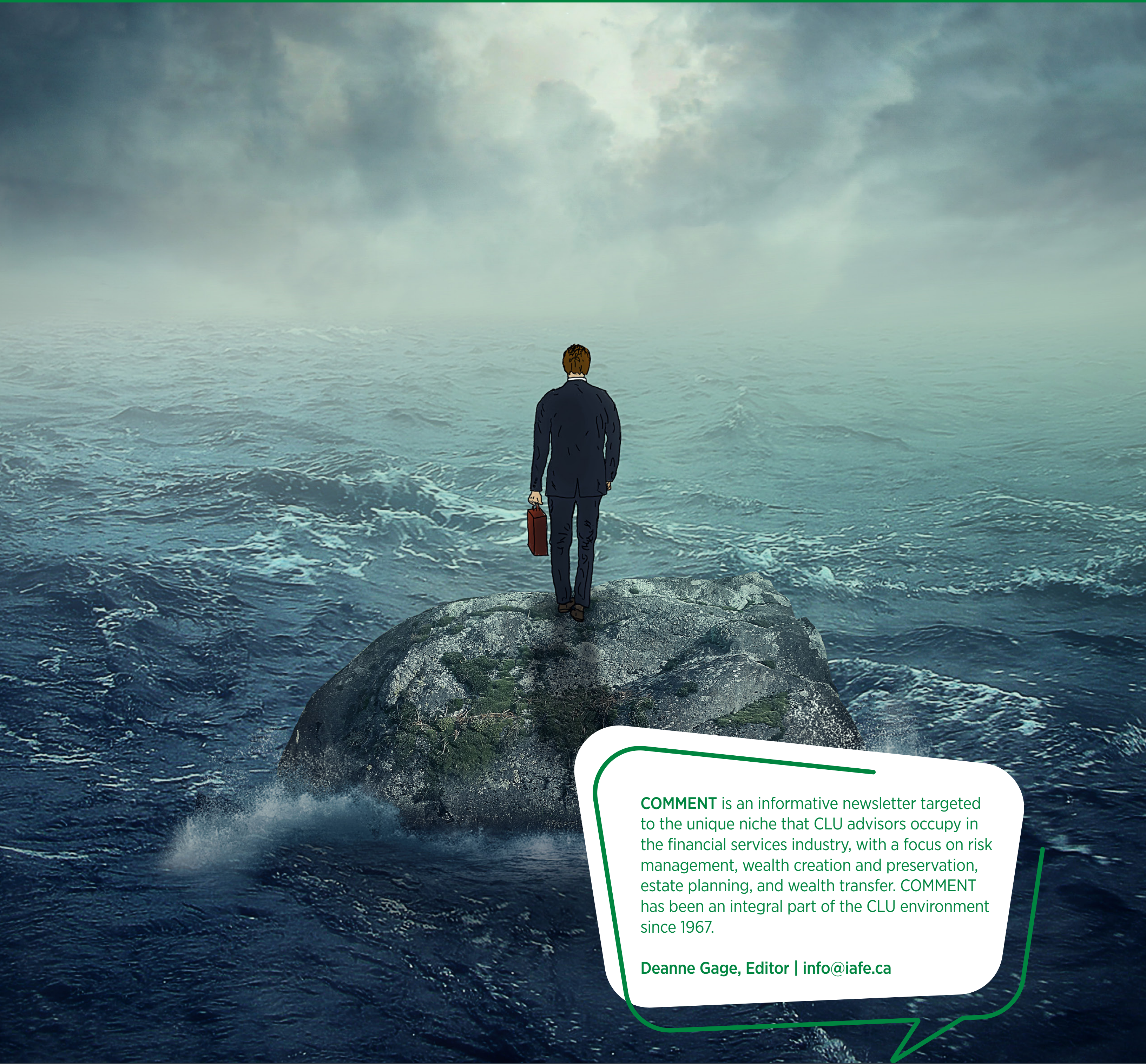
[1] *See ss. 237 and 238(1) of the* Business Corporations Act, *R.S.O. 1990, C.B. 16.*

[2] *See s. 312 of the* Business Corporations Act*, CQLR cS-31.1*

[3] *See s. 25(1)* Forfeited Corporate Property Act, *2015, S.O. 2015, c. 38, Sch 7*

[4] *See the* Escheats Act*, C.C.S.M. c. E140, s. 1, where property of any kind is forfeited to the Crown, the Crown will take a position to deal with that property*

[5] *See s. 208(1) of the Alberta* Business Corporations Act, *RSA 2000, Chapter B-9*



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.

Deanne Gage, Editor | info@iafe.ca