Valuing corporate owned life insurance – A new twist

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Leadership in innovative advanced planning solutions and advocacy to promote the financial health of Canadians.

Mission

CALU promotes a deeper understanding of complex financial and tax initiatives for members and clients and advocates for sound public policy.

Background

The tax rules governing the valuation of corporate owned life insurance, for purposes of determining the fair market value (FMV) of a private company shares on a shareholder's death,[1] are well established. Subsection 70(5.3) of the Income Tax Act (the Act) provides that in valuing the shares of the corporation, the FMV of any corporate owned life insurance on the life of that shareholder (or the life of certain non-arm's length persons) is deemed to be the cash surrender value (CSV) of the policy immediately before death.

For example, assume Ms. A owns all the shares in Opco. Opco owns a $1 million life insurance policy on Ms. A's life. Ms. A passes away and at that time the CSV of the policy on her life is $50,000. In determining the FMV of her shares for purposes of the deemed disposition rules on death, only the policy's CSV ($50,000) should be considered. In other words, the death benefit payable under the policy is not relevant in determining the FMV of Ms. A's shares in Opco.

The Canada Revenue Agency has also indicated that the terms of a buy-sell agreement which determine the value of shares on the death of a shareholder may displace the rule in subsection 70(5.3) and govern share value on death. For example, if an agreement specifies a valuation formula for determining the purchase price of shares on the death of a shareholder, the value determined by that formula could govern the determination of the FMV of the deceased's shares for purposes of the Act.[2]

Determination of probate fees/taxes

It might be assumed that a similar approach to valuing corporate owned life insurance would be taken in determining the FMV of shares in a private corporation for probate tax purposes.[3] That is, only the CSV of a corporate owned policy on the shareholder's life would be relevant in determining the value of shares in that corporation for probate tax purposes. However, a recent court action in Ontario signals that this assumption may not necessarily apply in the probate context.[4]

The facts leading up to the *Crichton* court action are as follows: Mr. Greaves was the sole shareholder of three private corporations that were the owners and beneficiaries of life insurance policies insuring his life. Mr. Greaves passed away and the shares of these three corporations became part of his estate. The estate trustees applied for and were granted probate.[5] Estate administration tax was paid based on the estimated value of the estate, including the shares in the three private corporations. However, in determining the value of the shares, the insurance proceeds payable to the corporations was *not* included. The estate trustees also provided an undertaking confirming they would file a sworn statement of the actual value of the estate once it was determined and pay any additional estate administration taxes.

There was a question of whether the value of the life insurance policies should increase the FMV of the three corporations for probate tax purposes, which would result in higher estate administration taxes payable by the estate. The Ministry of Finance (the Minister) offered to provide the estate trustees with an advanced tax ruling on this issue. However, this offer was declined and instead the estate trustees brought an application to the Ontario Superior Court seeking a determination of whether life insurance proceeds payable to private corporations should be included in the value of the shares for purposes of calculating Ontario estate administration taxes.

The Minister opposed this motion on the basis that there is a separate mechanism for

1 As required under subsection 70(5).
2 Refer to paragraphs 17-31 of Information Circular IC 89-3 dated August 25, 1989.
3 Ontario levies an estate administration tax that is generally equal to 1.5% of the value of estate assets above a very low threshold.
4 Crichton v. Ontario (Minister of Finance) 2021 ONSC 8012. Herein referred to as "*Crichton*".
5 In Ontario this is referred to as a Certificate of Appointment of Estate Trustees with a Will.

taxpayer objections and appeals under the Estate Administration Tax Act (EATA).[6] The Minister argued that the proper way for the estate trustees to deal with this issue would be to self-assess (that is, take a position on value) and then wait until the Minister had assessed the tax payable by the estate. Only at this stage should the Court be engaged in considering the estate's appeal from such an assessment. The estate trustees challenged the Minister's position on the basis that Court has an inherent jurisdiction to deal with functional gaps in legislation, such as in this present case where there has been no assessment, objection or appeal that would engage the legislated objection/appeal procedures.

The Court reviewed the applicable legislative provisions and related case law and accepted the Minister's position that the current situation involved a tax dispute that fell squarely within the parameters of the EATA. The Court noted that this determination did not preclude the estate trustees from making a future appeal to the court if they ultimately disagreed with the Minister's assessment. The Court also indicated that this decision should not be construed as offering any opinion on the technical merits of the application.

CALU request for interpretation

Upon learning about this issue earlier in 2021, and prior to the release of this court decision, CALU had written to the Minister seeking its views on whether an insurance death benefit received by a corporation on the death of a shareholder should be included in valuing the deceased's shares for purposes of the estate administration tax.

CALU also asked the Minister to consider the situation where there is a buy-sell agreement which is triggered by the death of a shareholder, and there is a formula in the agreement for determining the value of the deceased's shares. We requested the Minister's views on whether the share value calculated by such a formula would be determinative of the value of the deceased's shares for estate administration tax purposes.

The Minister has now responded to CALU's request for an interpretation. The Minister indicated that it was not the government's policy to provide a binding interpretation regarding an unidentified client or situation. However, they were prepared to provide some general information that might be of assistance in understanding the administration of the EATA.

The Minister's response went on to state that the estate administration tax is payable on the value of the estate of a deceased if an estate certificate is applied for. Value of the estate means the value of all assets belonging to the deceased at the time of death, and not just assets for which probate is required. In the situation where the deceased owned shares in a corporation at the time of death, the value of those shares will need to be included in the value of the estate. The FMV of the shares needs to be determined by the estate representative (and their accountant) and documentation evidencing the value produced if requested by the Minister.

Some clarification is required in relation to the Minister's response to CALU's request for an interpretation, as it may appear to suggest that all assets owned by the deceased must be included in the value of the estate for estate tax purposes. However, Ontario specifically recognizes the use of secondary wills.[7] Certain types of property that don't require probate to be administered[8] by the executors are typically included in a secondary will. The secondary will does not require probate and therefore no estate taxes are payable on property included in it.[9]

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6 S.O. 1998, C. 34. Section 4.6(2) of the EATA incorporates by reference the appeals process under the Ontario Retail Sales Tax Act, R.S.O 1980, c. R.31.

7 The other province is British Columbia.

8 The secondary will would typically include the testator's personal property and shares of a private corporation.

9 https://www.ontario.ca/page/estate-administration-tax. In circumstances where there is an Ontario estate with a secondary will, the estate executors would apply for a Certificate of Appointment of Estate Trustee with a Will Limited to the Assets Referred to in the Will. Only assets included in that specific will be included in the value of the estate.

Conclusions

Neither the court decision in *Crichton* nor the Minister's response to CALU's request for an interpretation provide any certainty relating to the issue of the valuation of corporate-owned life insurance in determining Ontario estate administration taxes. There is also the broader question of whether similar interpretive issues could arise in other high probate tax jurisdictions such as British Columbia and Nova Scotia.

As noted above, one way to avoid this issue in British Columbia and Ontario would be to have a secondary will governing the corporate shares, which does not require probate or the payment of estate taxes on the value of the corporate shares. Having a buy-sell agreement between the shareholders which specifies the FMV of a deceased's shares may also be determinative of the value of those shares for Ontario estate tax purposes. The FMV of fixed value preference shares (such as those issued under an estate freeze) would also not be influenced by future growth in the value of corporate assets resulting from the receipt of life insurance proceeds.

CALU will continue to monitor this issue and update members as we receive more information. In the meantime, the potential for increased estate taxes should be considered by Ontario clients and their professional advisors when contemplating the purchase of corporate-owned life insurance.

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