April 29, 2016

Mr. Andrew Marsland
Assistant Deputy Minister
Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, ON. K1A 0G5

Dear Mr Marsland:

Re: March 22, 2016 Budget Proposals

I am writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU is a national professional membership association of established financial advisors (life insurance, wealth management and employee benefits), accounting, legal, tax and actuarial professionals. For 25 years CALU has engaged in political advocacy and government relations activities on behalf of its members and the members of its sister organization, Advocis. Through these efforts, CALU represents the interests of more than 11,000 insurance and financial advisors and in turn the interests of millions of Canadians.

Further to our recent meeting, we wish to provide you with our comments on proposed changes contained in the March 22, 2016 federal budget (the "budget proposals") relating to the tax treatment of certain transactions involving life insurance owned by partnerships and corporations. More specifically, we wish to comment on Clauses 56, 57, 58 and 59 of the Notice of Ways and Means Motion (the "life insurance proposals") released as part of the budget proposals.

Broadly speaking, the life insurance proposals are meant to address two different planning arrangements involving life insurance as described below. For simplicity we'll limit our comments to those arrangement involving private corporations, although these comments also generally apply to the budget proposals as they affect life insurance owned by a partnership.

1. Corporate-Owned Insurance with a Beneficiary Designation in Favour of another Related Corporation

a) Introduction

It is a fairly common practice for individual shareholders to establish holding companies (a "Holdco") to own shares in a private corporation that carries on an active business (an "Opco"). There are a number of valid tax and non-tax reasons for establishing a Holdco-Opco structure including the ability to:

- Include non-active family members (directly or through a trust) as shareholders without the consent of shareholders in the Opco.
- Regularly "purify" Opco for purposes of maintaining access to the capital gains exemption.
- "Creditor protect" assets by transferring property to the Holdco level.

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- Facilitate the different estate planning objectives of shareholders in Opco.
- Keep assets in Holdco that are to be retained in the event of the sale of the Opco shares.

There are also a number of valid business reasons for a private corporation to own life insurance on the life of a shareholder, including key-person insurance, collateral insurance, and funding for a buy-sell agreement that may involve other family member shareholders and/or arm's length shareholders.

Where the individual shareholder(s) have established a Holdco-Opco arrangement, and life insurance is required for business purposes, it is common for the insurance to be owned by the Holdco. This protects the policy from creditors of Opco, and permits the retention of the policy should Opco be sold in the future. However, the insurance benefit itself may be required in Opco. For example, Opco may be obligated under a buy-sell agreement to redeem the shares of a deceased shareholder. In these situations Holdco will own and pay the premiums under the insurance policy on the life of the shareholder, with Opco designated as the beneficiary.

While there are valid business reasons for arranging the life insurance in this manner, there is also the potential for an enhanced addition to the capital dividend account (CDA). Where Holdco is both the owner and beneficiary of the insurance policy, the addition to the CDA is equal to the life insurance death benefit less the adjusted cost basis (ACB) of the insurance policy.[1] However, where the corporate beneficiary of the policy is different from the owner of the policy, the CDA addition will be equal to the full amount of the life insurance death benefit because the corporate beneficiary does not have an ACB in the insurance policy.[2] It is important to note that any enhancement to the CDA will diminish over time, since the ACB of the policy generally declines as the life insured grows older.[3]

The budget proposals will effectively eliminate the potential for an enhancement to the CDA in the circumstances described above by reducing the CDA addition by the ACB of a policyholder's (rather than the beneficiary's) interest in the policy. The proposed changes will apply to any life insurance proceeds received as a result of a death that occurs on or after March 22, 2016. In addition, the budget documents indicate that an information reporting requirement will apply where a corporation or partnership is not a policyholder but entitled to receive a policy benefit.

b) Discussion of Proposed Rules - For Split Ownership – Beneficiary arrangements entered into On or After March 22, 2016

CALU is generally supportive of the proposed changes as they apply to split ownership - beneficiary arrangements that are put in place on or after the budget date. However, we note there is an issue that has been identified, which can arise where the policy has more than one insurance coverage (a "multi-life policy"). For example, a corporate owned policy may have separate coverages on two or more lives but has only one ACB at the policy level. Under current rules the ACB for this type of policy is not adjusted for any payment arising under the policy upon the death of a life insured. For policies issued after 2016, the ACB of a multi-life policy will be reduced where there is

[1] By virtue of paragraph (d) of the definition of capital dividend account in subsection 89(1) of the Income Tax Act (the "Act").
[2] This result was confirmed by the CRA in Technical Interpretation 9908430 dated June 30, 1999. The CRA further indicated that unless there are bona fide reasons, other than to obtain a tax benefit, for this insurance structure, there may be a reasonable argument to apply subsection 245(2) of the Act to reduce the CDA by the ACB to the owner of the policy at the time of death.
[3] This is because the ACB of a policy is reduced by the "net cost of pure insurance" ("NCPI"). The NCPI is a notional mortality charge for the cost of insurance which increases as the life insured ages, and will eventually exceed the total of all premiums paid into the policy. See Appendix A for two examples which demonstrate this.

the payment of a death benefit under the policy and the policy continues to be in force.[4] It is important to ensure that such ACB adjustment also takes place where there is a split ownership-beneficiary arrangement for policies issued after 2016. In effect, the tax result should be no different than if the recipient corporation was also the owner of the policy.

A similar concern arises where there is more than one corporate beneficiary designated under a corporate owned policy. In these circumstances we believe the ACB of the policy must be appropriately allocated between the respective interests in the death benefit payable under the policy for purposes of determining the addition to the recipient corporation's CDA.

We are also of the view that since the definition of CDA is under review, there is an opportunity to address another concern previously raised by CALU. We recommend that the definition of CDA also be amended to extend the same type of CDA character to life insurance death benefits received by a trust and distributed to a private corporation, as has been done in respect of the non-taxable portion of capital gains and capital dividends received by a trust. Attached as Appendix B is a letter to Finance dated February 4, 2009 providing further rationale for this requested change. CALU would appreciate the opportunity to discuss this amendment as part of Finance's review of the CDA definition.

We would also appreciate receiving clarification as to who will have the reporting obligation where a corporation or partnership is the beneficiary of a life insurance policy but does not own that policy. In particular, will the reporting obligation fall on the owner of the policy or the insurance company that issued the policy, and what will be the nature of the reporting obligation? If this requirement will be imposed on insurance companies, this could result in significant new systems and administrative costs, particularly if it applies to both existing as well as new arrangements.

c) Discussion of Proposed Rules – For Split Ownership-Beneficiary Arrangements in Effect before the Budget Date

It is important to note that the rules being relied upon for calculating the CDA addition under a split ownership-beneficiary arrangement have been in place since 1985. As well, confirmation of the correct CDA addition where there is a split ownership-beneficiary arrangement was first brought forward by CALU at its CRA Roundtable in May 1999. At that time the CRA confirmed this was the correct interpretation of the legislation.[5] CALU further raised this issue as part of the exempt test consultation process that took place from 2012-2014, and provided draft legislation to Finance in 2012 that would have corrected this anomaly. Despite this, Finance chose to not make any changes to the CDA definition.

Given this history, we want to express our concerns that the budget proposals will apply to arrangements that were put in place before the budget date. We believe that taxpayers should be entitled to rely on long standing legislation in structuring their affairs where it otherwise has a valid business purpose.[6] In particular, caution should be exercised when changes affect the tax treatment of life insurance and/or the distribution of such proceeds, as modifications to existing arrangements may not be possible due to changes in insurability and/or product design and pricing. As a result, where the intent is to distribute the insurance proceeds as a capital dividend to a shareholder in order to meet a contractual obligation (such as one imposed under a buy-

[4] New Variable O in the definition of adjusted cost basis in subsection 148(9) of the Act, effective for policies issued after 2016.
[5] The CRA did indicate that it would use the General Anti-Avoidance Rule to challenge arrangements where the main purpose was to maximize the CDA addition.
[6] We'd note that where there is no valid business purpose for this structure, the CRA can challenge the arrangement under the general anti-avoidance rule in subsection 245(1) of the Act.

sell agreement), the proposed changes could result in a funding shortfall on an after-tax basis. It is therefore our view that arrangements in place before the budget date should continue to benefit from the tax rules that existed at that time.

We would be pleased to engage in discussions on how the application of these rules could be modified to respect arrangements in effect before the budget date while achieving Finance's goals and objectives.

2. Dispositions of Insurance to Non-Arm's Length Persons

a) Introduction

An individual may have originally acquired life insurance on his or her life for personal and/or business purposes. At a later date, due to the incorporation of a business or change in business circumstances, it may be determined that the corporation should be the owner and beneficiary of the policy. This may arise, for example, to secure corporate debt, provide key person insurance coverage and/or fund a buy-sell arrangement that is triggered on the life insured's death.

When a life insurance policy is transferred from an individual shareholder to a corporation with whom that shareholder is not dealing at arm's length, subsection 148(7) of the Act provides rules that determine the proceeds of the disposition to the shareholder and the cost to the acquiring corporation.[7] In effect, the deemed proceeds of the disposition is equal to the "value" of the policy (i.e. the cash surrender value ("CSV") of the policy[8]) and the transferee is deemed to have acquired the policy for an amount equal to the shareholder's deemed proceeds.

There may be situations where the fair market value of a life insurance policy exceeds its CSV. This can arise where the policy has been in force for a number of years (reflecting the value of premiums paid in the past and where the life insured is closer to his or her assumed life expectancy) and/or there has been a deterioration in the health of the life insured. In these circumstances it would also make financial sense (and also be generally reflective of other tax rules governing non-arm's length transactions) to transfer the insurance policy to the corporation for an amount reflecting its fair market value, with the shareholder receiving cash, debt or shares in the corporation.

In these circumstances the following are the tax outcomes:

- The shareholder will be deemed to have received proceeds equal to the policy's CSV, rather than the fair market value of the consideration received on the transfer. The shareholder will report an income gain to the extent those deemed proceeds exceed the ACB of the policy.[9]
- The corporation will acquire the policy at a cost equal to the policy's CSV, which is less than what was actually paid for the policy. This can have negative tax results for the corporation if the policy is subsequently surrendered, as the policy gain determined on surrender may have been lower if the corporation's cost reflected the fair market value of any consideration paid for the policy. Alternatively, it can have positive tax results if the policy is held until the death of the life insured, as the CDA addition may be higher than would otherwise have been the case if the corporation's cost reflected what had actually been paid for the policy.

[7] It should be noted that subsection 148(7) of the Act is broader in scope, also applying to gifts of insurance, distributions of insurance from a corporation, transfers by operation of law, or any other disposition to a person who is not dealing at arm's length with the transferor.
[8] The term "value" is defined in subsection 148(9) of the Act.
[9] Subsection 148(1) and paragraph 56(1)(j) of the Act.

- Assuming the fair market value of the consideration paid by the corporation is less than or equal to the fair market value of the policy, there would be no shareholder benefit on the transfer.[10]

The budget proposals will amend subsection 148(7) of the Act to increase the deemed proceeds of disposition to the shareholder by an amount equal to the difference, if any, between the fair market value of the consideration given for the interest and the CSV of the interest in the policy. The cost to the corporation of acquiring the policy will be increased by a similar amount. For non-arm's length transfers that took place before the budget date, where the life insured is still alive, the budget further proposes to reduce the CDA addition to the transferee corporation upon the death of the life insured, by the difference, if any, between the fair market value of the consideration given for the interest on the prior transfer and the CSV of the interest in the policy at that time.

b) Discussion of Proposed Rules - For Non-Arm's Length Policy Transfers Implemented on or after March 22, 2016

CALU is again generally supportive of the proposed changes to section 148(7) of the Act for non-arm's length transfers entered into on or after March 22, 2016. However, there is a concern relating to the tax reporting requirements of an insurance company that has issued a policy that is subject to a transfer to which proposed subsection 148(7) of the Act would apply.

Currently, where the insurance company is notified of a non-arm's length transfer of a life insurance policy, it will report a gain to the transferor to the extent the CSV of the policy exceeds the ACB of the policyholder's interest in the policy. It is our understanding that not all insurance companies currently verify what consideration, if any, has actually been paid on the transfer. And in those circumstances where such information is requested, the policyholder may refuse to provide this information or not provide accurate information. Under the proposed changes to subsection 148(7) of the Act, these issues pose practical tax reporting difficulties for insurance companies.

A similar concern arises in tracking the ACB of the transferred policy. Under the proposed rules, the greater of the CSV of the policy and the fair market value of any consideration paid for the interest in the policy must added to the ACB of the policy.[11] Again, if the policyholder refuses to disclose the transfer price or reports inaccurate information, the insurer will not be able to properly determine and report the correct ACB.

The CRA has previously indicated, with respect to an arm's length transfer of a life insurance policy, that the insurer can generally rely on the information provided by a policyholder relating to the consideration paid for the policy, in discharging its tax reporting obligations.[12] There would be significant concern if the insurance company, in discharging its tax reporting obligations under proposed subsection 148(7) of the Act, would have a further obligation to independently verify the fair market value of consideration paid for the policy. We would appreciate your comments on whether Finance is contemplating any additional reporting requirements over what is currently the case for arm's length life insurance transfers.

[10] Subsection 15(1). See also CALU 2002 CRA Roundtable Q.6 (2002-0127455) where this type of fact situation was posed to the CRA and it confirmed these tax results. At that time the CRA also indicated that "we previously brought this situation to the attention of the Department of Finance and have been advised that it will be given consideration in the course of their review of policyholder taxation."

[11] Element "A" in the ACB calculation is the "cost of the interest in the policy to the policy owner".

[12] CRA Technical Interpretation 2002-0155555 dated October 11, 2002.

In addition to these reporting and compliance concerns, , there are a number of outstanding questions relating to subsection 148(7) of the Act, particularly in respect of transfers of life insurance between shareholders and private corporations, we believe should be addressed at this time, as outlined below.

First, there are other provisions in the Act that govern the disposition of property in non-arm's length situations that appear to conflict with the rules in subsection 148(7) of the Act. This can lead to uncertainty in terms of the tax results of certain non-arm's length transactions involving the transfer of life insurance between shareholders and corporations. For example:

- The CRA has indicated that the rules for wind-ups in subsection 88(1) of the Act will apply and override the rules in subsection 148(7) of the Act.[13]
- The CRA has also indicated that subsection 69(5) of the Act rather than subsection 148(7) will apply where the disposition of the life insurance policy occurs pursuant to a subsection 88(2) wind-up.[14]
- It is unclear whether the transfer of a life insurance policy as a dividend in kind to a shareholder will be governed by subsection 52(2) or subsection 148(7) of the Act.

As part of its review of subsection 148(7), we would recommend that Finance clarify which of these various rules will apply to a non-arm's length transfer of a life insurance policy.

Second, we believe the tax rules should generally provide the option to permit such transfers of life insurance policies to take place on a rollover basis, unless there is a valid policy reason for another tax result.

Third, there is some uncertainty regarding what impact, if any, the proposed changes to subsection 148(7) of the Act will have on gifting of life insurance policies to registered charities. We would like to receive confirmation that there is no generally no change in how the rule will apply in these circumstances.

And finally, CALU renews its request that as part of the process of revising subsection 148(7), Finance also enact a rule similar to section 85 of the Act that would permit the transfer of a life insurance policy from a shareholder to a private corporation on a rollover basis. Attached as Appendix C is a letter to Finance dated February 4, 1999 which outlines in more detail the rationale on the need for a rollover provision. We look forward to engaging in further discussions with Finance on this topic.

c) Discussion of Proposed Rules - For Non-Arm's Length Policy Transfers Implemented before the Budget Date

CALU is very concerned with the retroactive application of these budget proposals for the reasons outlined below.

The tax consequences associated with a life insurance policy are an integral component of the insurance product itself. The fact that the policy death benefit is tax-free, that the accumulating values within an exempt policy are not subject to accrual taxation, and that the calculation of the addition to a corporation's CDA from the life insurance proceeds, are only reduced by the ACB of the policy, are all key considerations in selecting the type and amount of insurance being purchased, as well as who will be the owner and

[13] CRA Technical Interpretation 2005-0116631C6 dated May 3, 2005. See also CRA Technical Interpretation 2015-0573841C6.

[14] Ibid. The CRA expressed the view that where two provisions of the same statute conflict, the more specific provision takes precedence. However, they would like to review the facts of the particular case to ensure that this provides a reasonable result.

beneficiary of the policy. In our view, changes to the tax results of owning or transferring an in-force life insurance policy should only be made where there has been a clear abuse of the tax provisions.

In fact, this is the position that Finance adopted as part of its recent review of the exempt test and policyholder tax rules. A number of technical anomalies in the application of the rules in section 148 were identified, arising from changes in policy design and features, as well as tax interpretations provided by the CRA. Some of these anomalies can lead to detrimental tax results for affected policyholders, while in other cases they offered the opportunity for "unintended" tax benefits. However, in discussions on the new rules, both the insurance industry and Finance agreed that, irrespective of whether the rules worked for or against the policyholder, the current rules would be maintained for policies issued before 2017, unless there were "significant" changes made to the policy after 2016, in which case the policy would fall under the new rules.[15]

Finance has been aware of the issues relating to subsection 148(7) since at least 2002.[16] This issue was also raised by CALU with Finance in 2011 as part of discussions relating to our letter to Finance dated February 4, 2009, as well as during the consultation process on the exempt test and policyholder tax rules. CALU indicated support for such changes on the assumption that such changes would be prospective in nature. We believe that, what is in effect, a retroactive change to rules that on their face are quite clear and directive, and in circumstances where Finance had several opportunities to make changes they felt were required, creates an unfair and even disturbing message for the insurance industry and life insurance policyholders who relied on the legislation that was in effect at the time they purchased their policies and subsequently entered into contractually permitted policy transactions.

The amendment to the definition of the CDA applies "if the death occurs on or after the Budget Day, an interest in the policy was disposed of before Budget Day, *and subsection 148(7) applied to the disposition…*" We note that subsection 148(7) of the Act was introduced into the Act in 1972.[17] This means that the proposed change to the definition of CDA could apply to transfers that took place over 40 years ago, and in turn the relevance of these proposed legislative changes may not become known to the corporate owner and its shareholders until the death of the life insured, which may be many years in the future. This not only demonstrates the issues with the retroactive application of tax changes to life insurance policies, but in our view also creates a significant concern relating to taxpayers having the required information to be able to comply with this proposed legislation.

Finally, the budget proposals could lead to a tax result that is significantly harsher than what would be the result if the transfer had taken place on or after the budget date. Consider the situation where Mr. A acquires a $1 million policy on his life, and funds the policy on a "minimum pay basis".[18] Subsequently Mr. A incorporates a company to carry on an active business and brings in a business partner. In 2015 the corporation seeks to borrow funds to expand its operations and the bank requests $1 million of insurance on Mr. A's life as collateral security. Rather than acquiring a new insurance policy, Mr. A decides to transfer his personal policy to the corporation. An independent actuary is hired and the policy is valued at $150,000, which is approximately equal to the cumulative premiums paid to date by Mr. A on his policy. Mr. A decides to transfer the policy to the corporation for $100,000 in cash, at which time the ACB of the policy was equal to $100,000.

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[15] The conditions upon which a policy issued before 2017 will lose its grandfathered status are set out in subsection 148(11) of the Act.
[16] Supra note 10.
[17] It is based upon section 79D(8) of the Act which was enacted in 1970.
[18] The annual premiums paid are equal to the cost of insurance and administrative charges, resulting in the policy having no CSV.

Due to the application of the new budget proposals, the CDA addition on the death of Mr. A will be "ground down" by $100,000, which is the difference between the fair market value of the consideration received by Mr. A and the CSV of the policy at that time.

Had this transfer taken place on after the budget date, Mr. A would be deemed to have disposed of his interest in the policy for proceeds equal to $100,000. Since the ACB of Mr. A's interest in the policy is also $100,000, there would be no gain on the disposition. In turn, the corporation would have an ACB in the policy of $100,000. Even if the company must continue to pay the insurance premiums to keep the policy in force, the annual NCPI charge will exceed premiums paid, such that the ACB of the policy declines to nil by the time Mr. A turns 70. In turn, the potential CDA addition increases each year that Mr. A continues to be alive, and will equal the full amount of the death benefit assuming Mr. A lives to age 70 or longer. Thus, Mr. A would have no gain on the transfer and it can be anticipated that the full amount of the insurance death benefit will be added to the CDA of the corporation.

As can be seen from the above example, the application of the budget provisions to a non-arm's length transfer before the budget date can result in a tax penalty versus the same transaction taking place on or after the budget date.

For these reasons we are opposed to any change in the CDA definition arising from non-arm's length transfers of insurance to corporations which took place before the budget date.

In summary, CALU would be pleased to participate in further discussions with Finance with a view to ensuring that the application of the budget proposals to existing arrangements is fair and equitable, and that other industry concerns with the CDA definition and subsection 148(7) of the Act are also given the +appropriate consideration by Finance.

Yours truly,

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cc. Roger Thorpe, RHU, REBC, GBA
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