calu

July 19, 2016

Mr. Brian Ernewein
Director General
Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, ON, K1A 0G5

Dear Mr. Ernewein:

Further to our meeting of June 16, 2016, I am writing to provide details on CALU's recommendations for transitional rules relating to certain insurance arrangements in place prior to the March 22, 2016 federal budget (the "2016 Federal Budget"). I have also taken the opportunity to summarize certain other issues relating to the federal budget that were identified in CALU's submission of April 29, 2016 (the "April submission").

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

As we discussed in our meeting, individual shareholders may choose to own insurance on their lives in a private corporation to fund business succession arrangements. Under such arrangements the insurance may be used to redeem fixed value preference and/or common shares of the deceased shareholder (or shares owned by a holding company of the deceased) and/or fund the payment of a dividend to the surviving shareholder(s) (or their holding companies) to purchaser the deceased's shares.

The amount of insurance that is purchased is dependent on a number of variables including the current and projected future value of the shares to be purchased, and the tax implications arising from the redemption of shares or payment of dividends. An important consideration is how much of the insurance proceeds will be credited to the capital dividend account ("CDA") of the recipient corporation, which in turn governs the tax treatment of the payment of dividends or deemed dividends as well as the application of other rules in the Income Tax Act (Canada) (the "Act") which apply on death.

Under the existing rules, where these arrangements are structured with one corporation as the owner of the policy and another corporation as the beneficiary of the insurance death benefit, the full amount of the insurance proceeds are added to the recipient corporation's CDA. However, by virtue of proposals in the 2016 Federal Budget, the amount added to the recipient corporation's CDA will now be reduced by the adjusted cost basis ("ACB") of the policy to the policyholder (the "CDA Proposal").

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This can result in an unexpected deficiency in funding the purchase of shares and/or after-tax proceeds available to the estate of the deceased. Purchasing additional insurance to ensure there is the required level of funding may not be an option where there has been a change in the insurability of any of the shareholders.

Transferring an existing policy to individual ownership may not be a viable option to address this issue due to the tax consequences associated with such a transfer. Such transfer will result in a disposition of the policy and trigger tax reporting to the corporate transferor, to the extent the cash surrender value ("CSV") of the policy exceeds the ACB of the policy.[1] In addition, if the transfer is a sale of the policy to the shareholder (as opposed to the payment of a dividend in kind), a taxable benefit may be assessed to the shareholder to the extent the shareholder does not provide consideration on the transfer equal to the fair market value ("FMV") of the policy.[2] In contrast, shareholders who implement an insured business succession arrangement on or after the 2016 Federal Budget have several options for ensuring there is an appropriate level of after-tax funding available at the individual shareholder level, including:

- Structuring the buy-sell agreement to operate at the personal level with insurance owned by the individual shareholders; and
- Having the corporation acquire additional life insurance on the life of each shareholder to provide the required after-tax funding at the individual shareholder level.

In recognition of the funding issues that can arise for arrangements in place before the budget date, CALU recommends the following:

- A special transition rule be introduced that is available where the CDA Proposal applies to corporate owned life insurance policies in place before the 2016 Federal Budget. The transition rule will permit the transfer of a corporate owned life insurance policy to an individual shareholder of the corporation (including through multiple tiers of corporations where, as part of the series, an individual shareholder receives the life insurance policy) as a dividend in kind, on a tax-neutral basis; and
- That the application of the CDA Proposal be deferred until April 1, 2017 to allow sufficient time for affected corporations and shareholders to consult with their advisors and determine the impact of these proposals on current arrangements and whether to utilize the special transition rule.

To achieve tax neutrality, it is proposed that the special transition rule apply as follows:

- Subsection 148(7) be read to deem the transferor corporation to have received proceeds of the disposition equal to the ACB of the policy, and the transferee shareholder to have acquired the policy at a cost equal to the deemed proceeds;
- Subsection 52(2) be read so that the cost of the life insurance policy received as a dividend in kind by a shareholder be equal to the ACB of the policy immediately before the transfer and that the corporation is deemed to dispose of the policy for proceeds equal to the same amount;

[1] Subsection 148(7) of the Act. This assumes no consideration is paid by the shareholder on the transfer of the policy or that the consideration is no greater than the CSV.
[2] Subsection 15(1) of the Act.

- The amount of the dividend in kind is deemed to be the CSV of the policy immediately before the transfer;
- Section 55 would not apply to the payment of the deemed dividend; and
- No other benefit or taxable amount would arise from the transfer of the insurance policy to the shareholder.

Access to the special transition rule would be subject to the following conditions:

- The corporate owner (the "owner") of the life insurance policy (the "policy") must be different from the corporate beneficiary (the "beneficiary") of the policy continuously from March 21, 2016 to the time immediately before the transfer of the policy;
- The life insured under the policy (the "insured") must be a Canadian resident shareholder (the "shareholder") of the owner of the policy continuously from March 21, 2016 to the time immediately before the transfer of the policy (the "transfer time");
- Both the owner and the beneficiary must be Canadian-controlled private corporations ("CCPCs") and related to each other continuously from March 21, 2016 to the time immediately before the transfer time;
- The policy must not previously have been transferred to the owner in circumstances where subsection 148(7) applied to the transfer and the fair market value of the consideration given by the owner exceeded the cash surrender value of the policy at the time of transfer;
- The owner and the shareholder must notify the life insurance company, and elect in their tax return for the year of transfer, that the transfer is to take place under the special transition rule; and
- The transfer must be legally completed before April 1, 2017.

Below is an example of how this special transition rule would apply.

> Mrs. Smith, a resident of Canada, owns all the shares in Holdco (a CCPC), which in turn owns 50% of the shares in Opco (also a CCPC). Holdco owns a $1 million life insurance policy on the life of Mrs. Smith with Opco as the beneficiary as at March 21, 2016. The insurance policy currently has a CSV of $200,000 and an ACB of $100,000. The insurance policy has been independently appraised and, due to a change in Mrs. Smith's health, the FMV of the policy is estimated to be $350,000. Holdco has been the owner and Opco has been the beneficiary of the policy continuously since March 21, 2016.
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> On February 12, 2017 Holdco transfers the policy to Mrs. Smith as a dividend in kind. Mrs. Smith and Holdco each make an election in their 2017 tax returns and notify the insurance company of this election as part of the transfer documentation.

Under the proposed special transition rule the tax consequences of this transaction would be as follows:

- Holdco will be deemed to have disposed of the policy for proceeds equal to $100,000 and there is no gain to be reported by Holdco. As well, Mrs. Smith will be deemed to have acquired the policy for proceeds of $100,000.

- Mrs. Smith will also be treated as having received a taxable dividend equal to the CSV of the policy ($200,000); and
- Upon Mrs. Smith's death the full amount of the insurance proceeds will be received tax-free by the named beneficiary under the policy.

This rule would provide tax relief to the corporate owner where the CSV of the policy exceeds the ACB of the policy. As well, it would provide tax relief to the transferee shareholder where the FMV of the policy exceeds its CSV. However, the shareholder would be required to report a taxable dividend to the extent the policy has a CSV at the time of transfer, unless the transferor corporation elects that the dividend be a capital dividend from existing CDA.

2. Non-Arm's Length Policy Transfers Implemented before the Budget Date

In our meeting of June 16 we discussed two specific areas where unintended tax results could arise from the application of the proposed rules governing non-arm's length policy transfers before March 22, 2016 (the "Pre-Budget Policy Transfer Rules").

The first concern arises because the Pre-Budget Policy Transfer Rules can impact any such transfer that has taken place since 1972. This poses a significant tax compliance issue because information relating to the FMV of consideration paid for policies in connection with transfers that took place many years ago may no longer be available. In our discussions it was suggested that the effective date be modified to apply to non-arm's length transfers taking place after 1999. We support this change as it is much more likely that insurance companies will have captured this information as part of the transfer documentation, and/or corporate records will be available to substantiate the consideration paid on the transfer of a policy.

The second concern is that the Pre-Budget Policy Transfer Rules, which grinds down the CDA addition for the corporation that receives the life insurance proceeds on the death of the life insured[3], appear to have been designed to recapture any tax benefit gained by the shareholder from the original policy transfer. In our view this is clearly a retroactive application of the proposed changes to the legislation in that it "reverses" a tax result that occurred under the legislation prior to the budget date. We continue to believe this is not appropriate given the prescriptive nature of subsection 148(7). Also, as noted in our example on page 7 of our April submission, the proposal can result in more onerous tax results than would be the case if the transfer took place on or after budget date.

However, we do recognize that a secondary tax benefit may arise from the transferee corporation having paid consideration for the policy that is not reflected in the ACB of the policy to the transferee corporation. This results from the fact that the addition to the CDA, due to the payment of the insurance proceeds, may be higher than otherwise would be the case if the consideration paid by the corporation was actually reflected in the ACB of the policy.

To equate this situation to the tax result that will arise for transfers on or after the budget date, CALU recommends that the excess of the FMV of the consideration paid by the corporation over the CSV of the policy at the time of transfer, be added to the ACB of the policy in determining the addition to CDA of the corporation. However, this excess amount would not be included in the ACB of the policy while the life insured is alive.

[3] Clause 57(2) of the 2016 Federal Budget Notice of Ways and Means Motion.

The following example illustrates the effect of this recommendation:

> Mr. A owned a $1 million policy with a $100,000 CSV and $50,000 ACB. The FMV of the policy was independently determined to be $250,000. Mr. A transferred the policy to a corporation he controls for $250,000 cash proceeds before March 22, 2016. A policy gain of $50,000 was reported by Mr. A on this transfer as the CSV exceeded the ACB by this amount. The corporation was deemed to have acquired the policy at a cost of $100,000. There was no shareholder benefit since the transfer price was equal to the FMV of the policy.
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> Mr. A dies in 2026, at which time the policy ACB has declined to nil due to adjustments arising from the net cost of pure insurance (NCPI). However, there would have been an additional $50,000 of NCPI adjustments had the ACB of the policy not already been reduced to nil prior to death (referred to in this example as “excess NCPI adjustments”).
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> Under the recommended approach, the ACB of the policy immediately after the transfer to the corporation would continue to be $100,000. However, the ACB of the policy at the time of Mr. A’s death (for CDA purposes) would be the ACB otherwise determined at the time of death (Nil), plus the difference between the consideration paid by the corporation less the CSV of the policy at the time of transfer ($250,000 - $100,000 = $150,000) minus any excess NCPI adjustments ($50,000). The ACB of the policy for CDA purposes would therefore be $100,000 (rather than $150,000 as determined under the budget proposals).

It should be noted that this secondary calculation only needs to be performed if the policy’s ACB, as otherwise calculated at the date of death, is nil. If the ACB is positive at the date of death, this means there are no excess NCPI adjustments that need to be factored into this calculation.

3. Other Issues to be Discussed from the April Submission (refer to attached)

(a) Split Ownership – beneficiary arrangements entered into on or after March 22, 2016

(i) Multi-life and split beneficiary arrangements – potential double counting of the ACB of the policy (refer to pages 2-3 of the April submission)

To supplement our April submission, CALU recommends that Clause 57(1) be amended as follows:

(A) if the death occurs before budget date, the interest in the policy referred to in subparagraph (i) or (ii) to the corporation, and
(B) if the death occurs on or after budget date, the interest in the policy referred to in subparagraph (i) or (ii) to the policyholder.

(ii) What is the nature of the reporting obligations? (refer to page 3 of the April submission)

(b) Transfers of Insurance to Non-Arm’s Length Persons – implemented on or after March 22, 2016

(i) Insurance company reporting requirements (refer to page 5 of the April submission)

(ii) Interaction of subsection 148(7) and other more general transfer provisions in the Act (refer to page 6 of the April submission)

We appreciate the opportunity to provide this additional submission to Finance and look forward to having further discussions on this matter.

Yours truly,

Kevin Wark, LLB, CLU, TEP
President CALU

cc. Clay Gillespie, CALU Chair
Warren Blatt, Chair, Government Relations
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