

Corporate-Owned Insurance — Valuation Issues Regarding the Deemed Disposition Rules at Death (Subsection 70(5))

Introduction

A common question asked by owner-managers who are contemplating the purchase of life insurance is whether the insurance should be owned personally or by their private corporation. Deciding between personal or corporate ownership is properly based on a number of tax and non-tax considerations. For an overview of these considerations, see the Tax Topic, "[Ownership of Life Insurance – Planning Considerations.](#)"

This Tax Topic reviews valuation issues involving corporate-owned insurance, specifically, the valuation of shares held by a deceased shareholder for capital gains purposes. Certain other valuation issues are also mentioned.

Valuation of corporate-owned insurance — general valuation

There are a number of circumstances when a valuation involving a corporate-owned life insurance policy is required under the Income Tax Act (the "Act"). When a specific income tax provision applies, the tax treatment and valuation is determined under the specific provision. However, when a specific income tax provision does not apply, Canada Revenue Agency ("CRA") uses general valuation principles to determine the value of a corporate-owned life insurance policy.

CRA has set out these general valuation principles in Information Circular IC 89-3 "Policy Statement on Business Equity Valuations" dated August 25, 1989. The Information Circular outlines the valuation principles, practices and policies that CRA generally considers and follows in the valuation of securities and intangible property of closely held corporations for income tax purposes. Determining the value of shares in a private corporation requires consideration of a number of fundamental factors, including the nature of the business, outlook for the company and the industry, the company's balance sheet, financial condition, earnings record, goodwill, etc. There are also numerous issues relevant to the valuation of specific shareholdings. The existence of corporate-owned life insurance is one of the relevant issues.

Although this Information Circular applies in determining the fair market value of shares in a corporation, CRA has indicated that the same factors listed in the Information Circular would be used to determine the fair market value of an interest in a life insurance policy in general.

Paragraph 40 of IC 89-3 lists the factors that are considered in determining the value of corporate-owned life insurance:

- a. the cash surrender value of the policy;
- b. the policy's loan value;
- c. the face value of the policy;
- d. the state of health of the insured and his/her life expectancy;
- e. conversion privileges under the policy;
- f. other policy terms, such as term riders, double indemnity provisions; and
- g. the replacement value of the policy.

The result of applying general valuation principles can produce a valuation which is materially different than the cash surrender value of the insurance policy. For example, if the death of one of the shareholders for which corporate life insurance is owned is considered imminent and the general valuation principles apply, the resulting valuation will exceed the policy's cash surrender value and may actually approach the total death benefit attributed to the interest in the policy held by the corporation.

Clearly, valuation in these circumstances is not an exact science, but rather a reasonable estimate based on all known facts.

Deemed disposition upon death under subsection 70(5)

Subsection 70(5) of the Act provides that a deceased taxpayer is deemed to have disposed of each capital property (including private corporation shares) for proceeds equal to the fair market value of the property immediately before death. As a result, any accrued capital gain or capital loss will be realized for income tax purposes on the deceased's final income tax return unless a specific relieving provision applies (for example, subsection 70(6) of the Act under which the property may be transferred on a tax free rollover to a surviving spouse or spousal trust).

The fair market value of the deceased's shares in a private corporation must be determined for the deemed disposition rules. If a shareholder's agreement exists, the terms of the agreement should be determinative of the fair market value of the shares of the deceased shareholder for purposes of subsection 70(5) provided certain conditions are met. The conditions that must be met in order for a buy-sell agreement to be considered determinative of value pursuant to subsection 70(5) are contained in paragraph 28 of Information Circular 89-3:

- (a) The agreement must obligate the estate to sell the shares at death either under a mandatory sales and purchase agreement or at the option of a designated purchaser;
- (b) The agreement must restrict the shareholder's right to dispose of the shares at any price during the shareholder's lifetime;
- (c) The agreement must fix a price for the shares or set out a method for determining the price on a current basis; and
- (d) The agreement must represent a bona fide business arrangement and not a device to pass the decedent's shares to his/her heirs for less than an adequate and full consideration.

If a buy-sell agreement between non-arm's length parties meets these conditions, its provisions should be determinative of value, as long as it also meets the following criteria:

- (a) It is a bona fide business arrangement. In other words, while the parties to the agreement may be related, they must transact as they would at arm's length with strangers;
- (b) The stipulated price or formula price in the agreement provides full and adequate consideration, and represents the fair market value of shares determined without reference to the agreement at the time that it is executed; and
- (c) It is a legal and binding contract.

If the shareholder's agreement is not determinative of the fair market value of the shares for purposes of subsection 70(5) or if an agreement does not exist, then the question arises as to how a corporate-owned life insurance policy will impact the valuation of the deceased's shares.

For purposes of determining the fair market value of the shares owned by a deceased shareholder on death under the deemed disposition rules in subsection 70(5), subsection 70(5.3) specifically provides that the fair market value of a corporate-owned life insurance policy on the life of the deceased shareholder or any person not dealing at arms length with the deceased shareholder shall be its cash surrender value. The term "cash surrender value" is defined under subsection 148(9) of the Act to be the cash surrender value stated under the insurance policy, ignoring policy loans, policy dividends (other than paid-up additions) and interest payable on such dividends. CRA has indicated they would look to ordinary valuation principles in determining whether a policy loan would otherwise be considered in valuing the deceased's shares (Technical Interpretation #2003-0035675).

Subsection 70(5.3) provides specific rules for valuing a corporate-owned life insurance policy owned on the life of the deceased shareholder and related persons. However, these rules do not apply to other corporate-owned insurance policies held on the lives of other insureds (eg. the surviving shareholders if they are unrelated). Life insurance policies on the lives of any other person insured also represent assets of the corporation and must, therefore, be taken into account in valuing the deceased's shares. CRA has indicated in IC 89-3 that it will value corporate-owned life insurance policies on the lives of the surviving shareholders at fair market value, determined in accordance with the factors noted previously.

Therefore, when determining the fair market value of shares owned by a deceased shareholder, corporate-owned life insurance policies on the life of the deceased will be valued based on the cash surrender value of the policies, but corporate-owned life insurance on the lives of any other arms length insured will be valued using general valuation principles.

Subsection 70(5.3) applies in determining the value of any property (e.g. an interest in a trust or a partnership) not just shares. It also applies on a deemed disposition for a spousal trust on the death of a spouse (under subsection 104(4) of the Act) and for a taxpayer on departure from (or emigration to) Canada (under section 128.1 of the Act).

If special shares of the corporation are issued as a conduit for insurance proceeds to flow directly to a particular person the fair market value of those special shares is a question of fact according to CRA comments at the 2005 APFF Conference, (#2005-013811 and #2005-013836). They did, however, comment that generally it would be reasonable to distribute the cash surrender value of the corporate-owned life insurance policies among various classes of shares based on the rights and conditions attached to the shares in the same way as the overall value of the firm would be allocated among the various classes of shares.

Similarly, at the 2008 APFF Conference (2008-0286151C6) CRA was asked to comment on the valuation of special shares used as a conduit to flow term insurance proceeds to a particular person at death. CRA was asked to confirm that immediately before the taxpayer's death, the fair market value of the special shares, for the purposes of subsection 70(5) of the Act, would equal the issue value (term insurance, therefore no cash surrender value) and not take into account the value of the life insurance proceeds payable at death, since subsection 70(5.3) of the Act specifies that only the cash surrender value of the policy subscribed on the life of the deceased shareholder is to be considered in the valuation of the shares. Again CRA stated that they cannot express an opinion on fair market value without an exhaustive review of the property to be valued at a given time, however has agreed to examine requests from taxpayers concerning complex valuation issues.

Application of 70(5.3) to joint life and multi-life policies

Subsection 70(5.3) of the Act defines the value of a corporate-owned life insurance policy to be its cash surrender value for determining the fair market value of shares in a corporation at death. Effective for dispositions after October 1, 1996 this provision is applicable to multi-life or joint-life policies where the deceased shareholder is one of the lives insured under the policy.

This subsection is also applicable when valuing policies on other lives (if they do not deal at arm's length with the deceased shareholder) at cash surrender value. For example, if the corporation owns single life policies on

a shareholder, his spouse or any other related person (e.g., a son or daughter who may be working in the business and for which key person coverage was purchased by the corporation), the policies would be valued at their cash surrender value.

Valuation of shares held by spousal trust

If the shares of a corporation are transferred by a deceased shareholder to a spousal trust the shares are deemed to be disposed of at the end of the day on which the surviving spouse or common-law partner dies, pursuant to subsection 104(4). The fair market value of the shares must be determined at this time. The corporation may have purchased life insurance to provide estate liquidity upon the death of a surviving spouse or common-law partner. Valuation of the shares at the end of the day on which the surviving spouse or common-law partner dies will include the value of the insurance policy. Subsection 70(5.3) provides that the fair market value of such a policy will be deemed to be equal to its cash surrender value immediately before the death, and therefore only the cash surrender value will be included in the valuation of the shares owned by the spousal trust.

Disposition of shares by deceased shareholder's estate under the promissory note method

If a mandatory buy-sell agreement exists between the shareholders of a corporation and a death occurs, the deceased shareholder will be deemed to have disposed of shares in the corporation at fair market value immediately before death. Under subsection 70(5.3) the fair market value of corporate-owned insurance on the life of the deceased shareholder is deemed to be the cash surrender value of the policy.

Under the promissory note method, the deceased's estate will sell the shares of the corporation to the surviving shareholders before the proceeds from the corporate-owned life insurance are paid out of the corporation. CRA has consistently stated that, on the sale of shares by the estate to a purchaser with whom it does not deal at arm's length, an adjustment might occur under section 69 of the Act to include the value of the life insurance proceeds in the proceeds received by the estate, thereby increasing the capital gains tax liability to the estate. This view was expressed in response to Question 13 at the 1993 CALU Annual Meeting (technical interpretation letter 9310110, dated May 17, 1993). However, CRA also stated in this interpretation letter that if the disposition of shares by the estate is governed by a *bona fide* buy-sell agreement among shareholders, its provisions should be determinative of the value as stated in paragraphs 28 to 31 of IC 89-3 (outlined above). If the agreement is not *bona fide* then valuation would be a question of fact.

Conclusion

Corporate-owned insurance continues to be an attractive ownership alternative, particularly in owner-manager business situations. The decision to purchase insurance personally or through the corporation is properly based on the specific facts of each case. However, when analyzing the corporate ownership alternative, the impact of the corporate-owned insurance on the deemed disposition rules at death pursuant to subsection 70(5) should be considered.

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