Last updated: February 2019

Transfer of an Insurance Policy Involving Corporations and a Shareholder or Employee

Introduction
There are many situations where a corporation may want to transfer a corporate-owned life insurance policy to the life insured. For example, the corporation may have purchased insurance on the life of an employee to fund a key person need. Once the employee has retired, the corporation no longer needs the life insurance coverage and the employee may be interested in assuming ownership of the policy. Another situation is where a corporation has life insurance coverage on the life of a shareholder for buy-sell funding purposes and the corporation is sold to a third party. The corporation no longer needs the coverage and the shareholder may wish to own the life insurance policy for personal estate planning needs.

This Tax Topic discusses the income tax implications of transferring a policy from a corporation to a shareholder or employee. It also discusses transferring an insurance policy from a shareholder to a corporation and transfers between related corporations (sister corporations). The transfer results in tax implications to both the disposing party (transferor) and the acquiring party (transferee).

Subsection 148(7) of the Act
A transfer of ownership of a life insurance policy is considered a disposition for income tax purposes. Subsection 148(7) of the Income Tax Act (the “Act”) provides the specific rules which apply to dispositions of an interest in a life insurance policy in the following situations:

- a gift of an interest (either during life or by way of will);
- a distribution of an interest from a corporation;
- a transfer of an interest by operation of law only to any person; and
- a transfer of an interest to any person with whom the transferor is not dealing at arm’s length.

Disposition and Acquisition on the Transfer
When a corporate-owned life insurance policy is transferred to any non-arms’ length person, whether for consideration or not, by way of a gift or a distribution from the corporation, subsection 148(7) applies. Canada Revenue Agency (“CRA”) indicated at the 2003 Conference for Advanced Life Underwriting (“CALU”) annual meeting (2003-0004285) that a sale for fair market value consideration of a policy to an arms’ length shareholder or employee could not constitute a “distribution” from a corporation and as a result, subsection 148(7) would not apply. Whether or not a shareholder or employee is dealing at arms’ length with a corporation is a question of fact. In general, related persons do not deal at arms’ length. A corporation and a person who controls the corporation or a person who is a member of a related group that controls the corporation are related; as are any two corporations if they are controlled

by the same person or group of persons. If fair market value is not paid by a non-controlling shareholder, either the situation may be viewed as a non-arm's length transaction or a distribution such that subsection 148(7) of the Act would apply. The remainder of this discussion assumes the transfer is to a non-arm's length person that may or may not have paid consideration and therefore, 148(7) is applicable.

For transfers after March 21, 2016, subsection 148(7) deems the proceeds of disposition to the transferor (i.e., the corporation) and the new adjusted cost basis ("ACB") to the transferee (i.e., the shareholder or employee) to be the greatest of:

- the "value" of the interest in the policy at the time of disposition,
- the fair market value ("FMV") of the consideration, if any, given for the interest in the policy, and
- the ACB to the policyholder of the interest in the policy immediately before the disposition time.

To the extent that the transferor's deemed proceeds of disposition are greater than the ACB of their interest in the policy, the corporation will realize a policy gain. This policy gain, if any, will be taxed as regular income. Losses, if any, are deemed to be nil. The shareholder or employee is deemed to acquire the interest in the policy at an ACB equal to proceeds of disposition.

The term "value" is defined in subsection 148(9) of the Act as the amount the holder of the policy would be entitled to receive if the policy were surrendered (essentially the cash surrender value (CSV) of the policy net of policy loans). It should be noted that the CSV of a term policy would normally be nominal or nil and as such, the value for the above calculation would be nil.

Taxable Shareholder/Employee Benefit

Subsection 148(7) deals with the acquisition and disposition of the life insurance policy. It does not eliminate the potential taxable benefit conferred on the shareholder or the employee as a result of the transfer of ownership.

The taxable benefit issue must be considered when contemplating a transfer of a corporate owned insurance policy to a shareholder or employee. CRA has consistently held that a shareholder benefit under subsection 15(1) or an employee benefit under paragraph 6(1)(a) will be taxed in the hands of the transferee to the extent the fair market value of the insurance policy exceeds the amount of the consideration paid by the shareholder or employee (see technical interpretation letter #9327305 dated Jan 13, 1994). The assessment of a taxable benefit is similar to the treatment when any asset is transferred out of a corporation.

In order to avoid the assessment of a taxable benefit the shareholder (or employee) should pay consideration to the corporation equal to the fair market value of the life insurance policy.

Fair Market Value of a Life Insurance Policy

The fair market value of a life insurance policy is difficult to determine and must be estimated based on the facts and circumstances of the situation. In general, the longer a policy remains in force, the more valuable it becomes. CRA has set out valuation guidelines in Information Circular IC 89-3 *Policy Statement on Business Equity Valuation*, which specifically outlines the valuation principles CRA considers when valuing shares of closely held corporations for income tax purposes. The information circular provides a list of factors that would be considered when determining the fair market value of corporate-owned life insurance.

Although this circular applies when determining the fair market value of shares in a corporation, CRA has indicated that the same factors 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 following factors that would be considered in determining the value of life insurance:

- the cash surrender value of the policy;
- the policy loan value;
- the face value of the policy;
- the state of health of the life insured and his/her life expectancy;
- conversion privileges;
- other policy terms, such as term riders, double indemnity provisions; and
- the replacement value of the policy.

Applying these general valuation principles can produce a fair market value which is significantly in excess of the cash surrender value of the policy. If the general valuation principles apply, the fair market value of an interest in life insurance may approach the total death benefit, if the death of the life insured is considered imminent. The taxable benefit to be included in the shareholder's (or employee's) income will be the excess of the fair market value over the amount of consideration paid to the corporation for the policy.

Adjustment to the ACB of the Transferee
A strict reading of the definition of "adjusted cost basis" in subsection 148(9) of the Act indicates that the taxable benefit, if any, is added to the ACB of the interest acquired by the shareholder or employee. Therefore, the ACB of the policy to the transferee would be the CSV plus the value of any taxable benefit included in the transferee's income. This treatment was confirmed in earlier CRA technical interpretations (technical interpretation letter #9327305). However, the ACB that results from this calculation may exceed the fair market value of the interest in the policy. In a technical interpretation letter dated April 16, 1997, the CRA indicated these results appeared to be inappropriate and that their views on the calculation of the adjusted cost basis to the transferee may need to be reviewed.

At the 2003 CALU annual meeting the question arose again and CRA indicated that where 148(7) applies and the transferee was required to include an amount in income as a benefit, only the excess of the fair market value of the policy over the CSV would be permitted to be added to the ACB of the transferee

Example 1: Corporate owned insurance transferred to shareholder
A corporation owns a life insurance policy on a shareholder. The shareholder is in the process of selling his shares in the corporation. Upon the shareholder's departure, the corporation will no longer have the insurance need and therefore wishes to transfer the policy to the departing shareholder.

The corporation is transferring ownership of the life insurance policy, therefore there is a disposition for tax purposes. The transfer is to a non-arm's length party, accordingly subsection 148(7) of the Act will apply. This subsection deems the proceeds of disposition for the corporation to be the greatest of: the value of the policy (i.e. CSV), the FMV of consideration given by the shareholder, and the ACB of the policy. The shareholder's new ACB is deemed to be equal to the same amount as proceeds of disposition. The difference between the FMV of the policy and the amount paid as consideration for the transfer will be considered a taxable benefit to the shareholder.

Let's assume the permanent life insurance policy has CSV of $125,000 and an ACB of $86,000. The shareholder has experienced some health problems and would be rated if he were to apply for insurance today. Accordingly, the estimated FMV of the policy is $150,000. A number of scenarios can result, depending on whether the shareholder pays consideration to acquire the interest in the insurance policy and the amount of the consideration, if any:

Situation 1: Corporation transfers the life insurance policy to the shareholder for no consideration.
Situation 2: Shareholder pays the corporation an amount equal to the ACB of the policy ($86,000).
Situation 3: Shareholder pays the corporation an amount equal to the CSV of the policy ($125,000).
Situation 4: Shareholder pays the corporation an amount equal to the FMV of the policy ($150,000).

	Transferor: Corporation			**Transferee: Shareholder**		
	Deemed Proceeds 148(7)	**ACB**	**Policy Gain 148(1)**	**Amount Paid**	**Taxable Benefit 15(1)**	**New ACB 148(7)**
Situation 1	125,000	86,000	39,000	0	150,000	150,000
Situation 2	125,000	86,000	39,000	86,000	64,000	150,000
Situation 3	125,000	86,000	39,000	125,000	25,000	150,000
Situation 4	150,000	86,000	64,000	150,000	0	150,000

Shareholder benefits are fully taxable to the shareholder without a corresponding deduction to the corporation and therefore, should be avoided if possible. The assessment of a taxable shareholder benefit can be reduced or eliminated if the life insurance is transferred as a dividend payable in kind to the shareholder. The dividend amount would equal the FMV of the policy. A transfer via a dividend in kind is discussed in more detail below.

Example 2: Transferring to a Corporate Shareholder
There may be situations where a corporation owns a life insurance policy and wishes to transfer the policy to a corporate shareholder. For example, a shareholder owns Holdco which owns Opco which in turns owns a life insurance policy on the life of the shareholder. For business reasons, Opco wishes to transfer the life insurance policy to Holdco.

The tax consequences discussed above will apply to this situation. There will be a disposition for income tax purposes and subsection 148(7) will apply as the transfer is a non-arm's length transfer. This subsection deems the proceeds of disposition for the operating company to be the greatest of: the value of the policy (i.e. CSV), the FMV of consideration given by Holdco, and the ACB of the policy. The holding company's new adjusted cost basis is deemed to be equal to the same amount as proceeds of disposition. The difference between the FMV of the policy and the amount paid as consideration for the transfer will be considered a taxable benefit under subsection 15(1) to the corporate shareholder.

Let's assume the life insurance policy has CSV of $125,000 and ACB of $86,000. The FMV of the policy is estimated to be $150,000. A number of scenarios can result, depending on whether Holdco pays consideration to acquire the life insurance policy and the amount of consideration, if any:

Situation 1: Opco transfers the life insurance policy to Holdco for no consideration.
Situation 2: Holdco pays Opco an amount equal to the ACB of the policy ($86,000).
Situation 3: Holdco pays Opco an amount equal to the CSV of the policy ($125,000).
Situation 4: Holdco pays Opco an amount equal to the FMV of the policy ($150,000).

	Transferor: Opco			**Transferee: Holdco**		
	Deemed Proceeds 148(7)	**ACB**	**Policy Gain 148(1)**	**Amount Paid**	**Taxable Benefit 15(1)**	**New ACB 148(7)**
Situation 1	125,000	86,000	39,000	0	150,000	150,000
Situation 2	125,000	86,000	39,000	86,000	64,000	150,000
Situation 3	125,000	86,000	39,000	125,000	25,000	150,000
Situation 4	150,000	86,000	64,000	150,000	0	150,000

Shareholder benefits are fully taxable to the corporate shareholder without a corresponding deduction to the transferring corporation and therefore, should be avoided if possible. The assessment of a taxable benefit can be reduced or eliminated if the life insurance is transferred as a dividend payable in kind to the corporate shareholder. Subsection 148(7) would still apply to deem the disposition and acquisition to take place at the greatest of policy value, consideration given and ACB. The CRA has confirmed that the shareholder (transferee) does not give consideration to the corporation (transferor) in respect of a policy transferred as a dividend in kind (#2017-0690331C6 and #2016-0671731E). However, if the dividend in kind is in satisfaction of a redemption of shares, the shareholder (transferee) gives the shares as consideration and their FMV is the consideration given to the corporation (transferor) for the life insurance policy (#2018-0761521C6). The example assumes the dividend in kind is not in satisfaction of a redemption of shares. The tax treatment of a dividend in kind is discussed in Archived Interpretation Bulletin IT-67R3 *Taxable Dividends From Corporations Resident in Canada*. The bulletin states that the value to be placed on a dividend paid by a corporation in assets other than cash is the fair market value of such assets at the date of transfer to the shareholders. The amount of the dividend would therefore be equal to the FMV of the life insurance policy even though the proceeds of disposition and the new ACB may be a different amount.

Situation 5: Opco declares a dividend to Holdco in an amount equal to the FMV of the life insurance policy ($150,000).

	Transferor: Opco			**Transferee: Holdco**		
	Deemed Proceeds 148(7)	**ACB**	**Policy Gain 148(1)**	**Taxable Dividend**	**Taxable Benefit 15(1)**	**New ACB 148(7)**
Situation 5	125,000	86,000	39,000	$150,000	n/a	125,000

If the transferor is connected to the transferee the dividend will be considered an inter-corporate dividend and may not be subject to taxation. Essentially, a corporation is connected to another corporation where the payor corporation is controlled by the payee corporation or where there is a greater than 10% interest. It should be noted, however, that subsection 55(2) of the Act could apply to recharacterize the tax-free intercorporate dividend into a capital gain. The 2015 Federal Budget expanded the application of subsection 55(2) to many common transactions involving the payment of a dividend within a corporate chain, including the payment of a dividend in kind in order to transfer a life insurance policy. The 55(2) analysis is beyond the scope of this article; however, in general there must be enough

safe income (tax paid retained earnings) in Opco to move the policy to Holdco without triggering a capital gain in Holdco.

Example 3: Transferring an insurance policy from a shareholder to a corporation
Another situation is where a shareholder owns a life insurance policy on a personal basis. For business and estate planning reasons, the shareholder wishes to transfer the life insurance policy to their wholly owned corporation.

The tax consequences discussed above will also apply to this situation. The shareholder has a disposition of the policy for income tax purposes. (It should be noted that a life insurance policy is not "eligible property" within the meaning of subsection 85(1.1) of the Act and therefore does not qualify for the section 85 rollover.) The transfer is between non-arm's length parties, as a result, subsection 148(7) will apply. This subsection deems both the proceeds of disposition to the shareholder and the ACB to the corporation to equal the greatest of: the value of the policy (i.e. CSV), FMV of consideration given by the corporation, and ACB of the policy.

Let's assume the life insurance policy has CSV of $125,000 and an ACB of $86,000. The FMV of the policy is estimated to be $150,000. A number of scenarios might result, depending on if the corporation pays consideration to acquire the life insurance policy and the amount of consideration paid, if any:

Situation 1: Shareholder transfers the life insurance policy to the corporation for no consideration.
Situation 2: The corporation pays the shareholder an amount equal to the ACB of the policy ($86,000).
Situation 3: The corporation pays the shareholder an amount equal to the CSV of the policy ($125,000).
Situation 4: The corporation pays the shareholder an amount equal to the FMV of the policy ($150,000).

	Transferor: Shareholder			**Transferee: Corporation**		
	Deemed Proceeds 148(7)	**ACB**	**Policy Gain 148(1)**	**Amount Paid**	**Taxable Benefit**	**New ACB 148(7)**
Situation 1	125,000	86,000	39,000	0	n/a	125,000
Situation 2	125,000	86,000	39,000	86,000	n/a	125,000
Situation 3	125,000	86,000	39,000	125,000	n/a	125,000
Situation 4	150,000	86,000	64,000	150,000	n/a	150,000

Where a shareholder is transferring a policy to their corporation and no consideration is given, the shareholder should consider taking consideration at least equal to the greater of CSV and ACB as this will not change the tax outcome. For example, in the above scenario the shareholder should consider taking consideration of $125,000 as it will not affect the policy gain and the shareholder will receive the $125,000 without any additional tax cost. The only exception would be if the ACB exceeds the FMV of the policy. If that is the case, then the difference between the FMV of the policy and the consideration received (the ACB) would be a shareholder benefit under section 15(1) of the Act.

Before proceeding with transferring a life insurance policy into a corporation consideration should also be given to the longer term implications of the strategy. Factors to consider when transferring an individually owned policy to a corporation include:

- A corporate owned policy is exposed to the creditors of the corporation;
- To avoid shareholder benefit tax issues, the corporation should generally be the beneficiary of the policy. Given this fact, consideration should be given to whether there is an appropriate and tax-efficient method of getting the death benefit to the intended beneficiary;
- Undesirable tax consequences (e.g., shareholder benefits, taxable policy gain) may arise if there is a need to transfer the policy out of the corporation prior to death (for example, if the corporation is sold);
- The CSV of the policy is a passive asset to the corporation that will affect the value of the shares of the corporation at death or on the emigration of the shareholder. As well, the CSV could impact eligibility of the shares for the enhanced capital gains deduction;
- The potential impact of the stop-loss rules on the taxation of the shares at death; and

- There may be tax consequences where a shareholder of the corporation becomes a non-resident. A capital dividend paid to a non-resident is subject to non-resident withholding taxes.

Example 4: Transfer between related corporations (sister companies)
Transferring a life insurance policy from one wholly owned corporation to another corporation wholly owned by the same shareholder uses the same tax rules as discussed above. For example, consider an individual that is the sole shareholder of two corporations: Corporation A and Corporation B. Corporation A owns a life insurance policy on the shareholder. The shareholder has determined that it would be preferable to have Corporation B as owner and beneficiary of the policy. Therefore, Corporation A transfers the life insurance policy to Corporation B.

The transfer is a non-arm's length transfer from Corporation A to Corporation B and accordingly subsection 148(7) applies. This subsection deems the proceeds of disposition to Corporation A to be the greatest of: the value of the policy (i.e. CSV), the FMV of consideration given by Corporation B, and the ACB of the policy. Corporation B's new ACB to be equal to the same deemed proceeds of disposition.

The life insurance policy has CSV of $125,000 and an ACB of $86,000. The FMV of the policy is estimated to be $150,000. A number of scenarios can result, depending on whether Corporation B pays consideration to acquire the life insurance policy and the amount of the consideration, if any:

Situation 1: Corporation A transfers the life insurance policy to Corporation B for no consideration.
Situation 2: Corporation B pays Corporation A an amount equal to the ACB of the policy ($86,000).
Situation 3: Corporation B pays Corporation A an amount equal to the CSV of the policy ($125,000).
Situation 4: Corporation B pays Corporation A an amount equal to the FMV of the policy ($150,000).

	Transferor: Corporation A			**Transferee: Corporation B**		
	Deemed Proceeds 148(7)	**ACB**	**Policy Gain 148(1)**	**Amount Paid**	**Taxable Benefit**	**New ACB 148(7)**
Situation 1	125,000	86,000	39,000	0	see below	125,000
Situation 2	125,000	86,000	39,000	86,000	see below	125,000
Situation 3	125,000	86,000	39,000	125,000	see below	125,000
Situation 4	150,000	86,000	64,000	150,000	see below	150,000

The transfer between sister corporations may also result in a taxable benefit to the shareholder of the transferee corporation. CRA was asked to comment on this scenario at the 2006 APFF Roundtable (2006-0197211C6). CRA's commentary confirmed that subsection 148(7) would apply to determine the disposition and acquisition amounts. CRA then applied a two-part test to be used in determining if a 15 (1) shareholder benefit would apply; if the transferor corporation is impoverished and the sole shareholder of the transferee corporation is enriched, the commentary suggests a shareholder benefit could arise. The transfer between sister corporations could also be deemed an indirect payment to the shareholder of the transferor corporation according to subsection 56(2) or a taxable benefit to the transferee corporation according to section 246 of the Income Tax Act. If either of these tax provisions apply, the shareholder or the transferee corporation could be assessed a taxable benefit equal to the amount the FMV of the policy exceeds the consideration given for the policy.

Conclusion

In situations where transferring a life insurance policy involves corporations and/or a shareholder or employee, the income tax implications for each party must be considered. The transfer results in tax implications to both the disposing party (transferor) and the acquiring party (transferee). The first is the disposition and acquisition of the policy as governed by a specific provision in the Act. The second is the assessment of a taxable benefit to the shareholder or employee.

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