

Life Insurance considerations for shareholders contemplating winding-up a corporation.

The Income Tax Act (Canada) (ITA) has two set of rules that deal with corporate wind-ups.

The first set of rules addresses a wind-up of a subsidiary corporation into a parent corporation (where both terms are defined in subsection 88(1) of the ITA). Property transferred (from the subsidiary corporation to the parent corporation) during this type of wind-up can be done on a tax neutral basis provided that all the conditions specified in the ITA are met.

The second set of rules addresses situations where a corporation's property is distributed to its individual shareholders (e.g. where a professional corporation is wound-up several years after the professional retires and no longer needs the corporation). In this case, Subsection 88(2) of the ITA is the relevant provision.

To determine the quantum of the tax outcome for a subsection 88(2) transaction with respect to a life insurance policy, if any, you will need to know the following about the policy:

- The Cash Surrender Value (CSV);
- The Adjusted Cost Basis (ACB);
- The Fair Market Value (FMV) and;
- Other share related information (refer to Information Circular 89-3, paragraph 40, for more details).

With this information, there are two options available for the transfer of the policy: a transfer *before the wind-up* or a *wind-up*. Let's look at each in more detail.

A) Transfer the policy before the wind-up

A disposition between related (i.e. non-arm's length) parties has both a potential policy gain to the corporation and a shareholder benefit.

First, the corporation will be deemed to have disposed of the policy for the greatest of the following: the FMV of consideration paid by the shareholder to acquire it, the ACB or the CSV. If the deemed Proceeds of Disposition (POD) are greater than the ACB, a policy gain will be reported to the corporation which will be fully taxable as passive income. No loss can arise.

The second step is to determine if there is a shareholder benefit. If the FMV of the policy is greater than the amount paid by the shareholder to acquire the policy, the difference will be considered a shareholder benefit which is fully taxable in the hands of the

shareholder and non-deductible to the corporation. The policy ACB is bumped-up to FMV in the hands of the shareholder.

Alternatively, the policy could be transferred as a dividend In-Kind. In this case, the POD is the greater of the policy ACB or CSV as no consideration is deemed paid to the corporation (unless the dividend is the result of a share redemption). Any resulting gain will be fully taxable as passive income, but the corporation may be able to recover a Refundable Dividend Tax on Hand (RDTOH) or utilize any balance in their Capital Dividend Account to reduce the tax impact to the shareholder. A non-corporate recipient shareholder is then taxed as receiving a dividend for the FMV of the policy but gets no ACB bump beyond the deemed POD. For corporate shareholders, you must take into consideration the potential implication of subsection 55(2) of the ITA. Finally, the corporate structure and the legal rights of the class of shares must be considered whenever a dividend is contemplated.

B) Wind-up

A wind-up that doesn't qualify under subsection 88(1)¹ likely results in a deemed dividend pursuant to 84(2) of the ITA. The deemed dividend is equal to the FMV of the assets distributed less the paid-up capital of their shares². If the life insurance policy is the only asset remaining, the POD will equal the FMV of the policy less the paid-up capital. The shareholder is taxed on this amount as a dividend and the corporation is taxed on any policy gain that may arise when the FMV exceeds the policy ACB.

Summary

Transferring a policy out of a corporation is a complex transaction that may have significant tax consequences for all parties involved. In cases where a wind-up is considered (other than a wind-up of a wholly owned subsidiary), it may be wise not to wind-up a company that holds a permanent life insurance policy with values. Rather, it may be more suitable to distribute all other assets and continue the corporation until death of the insured. The ACB may be significantly eroded or eliminated by the time the life insured reaches his/her life expectancy so the full death benefit could be distributed tax-free through the CDA. This avoids the tax that would be triggered if the company is wound up.

The cost of record keeping and tax filings for an inactive company must be compared with the tax costs associated with a wind-up involving a life insurance policy which has been in-force for many years.

Note

The ideas presented in this guide should be reviewed for suitability to individual circumstances. The information contained in this guide is general in nature and should not be construed as legal or tax advice. You and your clients are encouraged to seek the advice of other professionals such as legal and tax experts to ensure that the ideas presented are appropriate for the circumstances of the individual(s) for whom this plan is being considered.

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¹Subsection 88(1) addresses a wind-up of a subsidiary corporation into a parent corporation, which is not the focus of this bulletin.

²At the Canadian Life and Health Insurance Association 2015 round table, the CRA clarified that when distributing an interest in a life insurance policy to a shareholder in connection with the liquidation of a corporation under subsection 88 (2), the general rule is that the more specific provision takes precedence over the more general one when there is a conflict between two provisions of the Act. Accordingly, subsection 69 (5) should probably prevail over subsection 148 (7), subject to the context and the facts of the policy transfer.

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