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Transfer of insurance to a retiree

At the 2013 CLHIA Tax Conference CRA Roundtable (#2013-0481421C6 dated May 17, 2013) the CRA dealt with two questions involving the transfer of a life insurance policy to a retiree.

The first situation related to the transfer of a policy that was purchased for key person protection by the corporation subsequently transferred to an owner-manager at the time of retirement for no consideration.

This was exactly the same question asked at the 2003 CALU CRA Roundtable(see September 2003 As a Matter of Tax "Clarifying the Operation of subsection 148(7))." The CLHIA asked if the response to the 2003 question continues to be the CRA's current position. The CRA stated that their position had not changed.

To summarize the prior position, basically, subsection 148(7) of the Act applies on a transfer from a corporation to an employee/shareholder for no consideration. It deems the disposition of the policy to occur at the policy's cash surrender value (CSV), $125,000 in the example. The policy gain to the corporation is $75,000 - the CSV less the adjusted cost basis (ACB) of $50,000 in the example. The ACB to the retiree would also be deemed to be at CSV.

An assumed fact in the example was that the CSV is the policy's fair market value. Because the owner-manager did not pay for the policy, there would either be an income inclusion of $125,000 as an employee benefit (under paragraph 6(1)(a) of the Act) or as a shareholder benefit (under subsection 15(1) of the Act). Where the policy is transferred because of employment, the corporation would be entitled to a deduction for the fair market value income inclusion to the employee.

If the fair market value were higher than the CSV an addition to the ACB of the policy to the retiree would be permitted for the excess of FMV over the CSV. But this would only be where the income inclusion to the retiree was because of being a shareholder.

The more controversial part of the response from CRA related to the second part of the question. Essentially, the CRA was asked to confirm the tax consequences arising where a life insurance policy is transferred from a retirement compensation arrangement (RCA) to a retiree for no consideration. In the context of the question the retiree is a beneficiary of the RCA and is also a shareholder and senior officer of the employer and does not deal at arm's length with the RCA trust.

The CRA stated that section 107.2 of the Act would apply on the transfer. This section deems the RCA trust to have disposed of the policy for fair market value. This section would apply instead of subsection 148(7) of the Act.

The RCA would be required to report a taxable policy gain where the FMV exceeds the ACB of the policy and refundable tax would be payable in respect of this income at the trust level. At the same time, the RCA is deemed to have paid the FMV as a distribution to the retiree. This would offset the refundable tax payable on the disposition for the RCA trust. The retiree would include the FMV distribution in income and the FMV would be the ACB to the retiree of the policy.

The controversial part is this next bit. The CRA stated that it is important to examine if there is any "advantage" arising. The CRA made the following statement in this context:

> It is not clear under what circumstances an RCA would be holding a life insurance policy that provides for more than a nominal death benefit. The holding of such a life insurance policy would appear to have little to do with providing for benefits under the RCA in relation to retirement, a loss of an office or employment, or a substantial change in services rendered. The holding of such a life insurance policy by the RCA could give rise to an advantage, and therefore, advantage tax under section 207.62 of the Act.

The CRA then makes the ostensibly "helpful" suggestion that in order to avoid negative consequences for pre-2012 Federal Budget RCA's holding life insurance that the trustee has the option of making an in-kind distribution before the end of 2013 pursuant to transitional measures found in paragraph 44(3)(a) of Bill C-45. (See As a Matter of Tax October 2012 "RCA 'advantage' and 'prohibited investment' legislation in progress") There also was a very detailed technical interpretation (#2012-0470181E5 dated February 21, 2013) on how the transitional rules work and just what can be done in respect of the limited grandfathering provided in respect of RCA's impacted by the 2012 Federal Budget.

This commentary is disconcerting. First, given that a life insurance policy can be deemed to be an RCA, the application of the advantage rules appears a bit over the top. And to make matters worse, CALU followed up specifically on the point of deemed RCA's and reported that "the above position will also apply to life insurance that is deemed to be an RCA under subsection 207.6(2) of the Act."

So, if I get this right, the deemed RCA rules may apply to a life insurance policy and once deemed to be an RCA, the CRA could say, that the policy just deemed to be an RCA has "more than a nominal death benefit" so that an advantage exists and apply the advantage tax

There has been no commentary regarding how the CRA would determine the value of the advantage arising from the ownership of insurance. Remember the advantage tax is 100% on the value of the advantage under subsection 207.62(1) of the Act.

The discussion reported by CALU also states that the CRA commented that the advantage rules might be avoided by ensuring the insurance death benefit is not part of the RCA trust, for example, pursuant to a split dollar or shared ownership arrangement. However, such arrangements may also give rise to an advantage if the sharing of premiums and benefits is not done on a fair market value basis.

And of course, there is no definitive commentary or guidance on what is a fair market value sharing of costs and benefits under such arrangements generally. The most recent statement relating to this was made at the 2012 CALU CRA Roundtable Question 7 (#2012-0435661C6) briefly discussed in May 2012 As a Matter of Tax "Tax update from the CALU conference".

CALU is seeking live examples of situations where life insurance is held by RCA's to discuss with the CRA so it may comment on whether the insurance death benefit is "required" to fund retirement benefits and therefore should not be considered an advantage. Maybe this will help. We can only hope.

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