Focus INSURANCE

Corporate loophole closed

Life insurance transfers now assessed at fair market value

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Last March the federal budget introduced changes that affect tax treatment of life insurance policy transfers and deaths of policy holders. To examine them, we first must see how the *Income Tax Act* treats life insurance policies.

A corporation can be the beneficiary of a policy and may fund the policy by paying the premiums. While premiums are not usually deductible to the corporation, the benefit of having a corporation pay premiums is that premiums can be financed with corporate dollars, which is better than personal after-tax dollars. When an insured person dies, the corporate beneficiary usually receives the life insurance proceeds tax free, and an equivalent amount is added to a special corporate account called a "capital dividend account," which can be paid out as a capital dividend tax free.

This dividend is often paid out to the estate of the deceased shareholder to help pay the tax bill. It can also be used as part of a previous shareholders' agreement to buy out shares of the deceased shareholder.

Before the budget, proceeds on transfers of a policy to a closely held corporation were deemed equal to the cash surrender value (the total the insurance company pays to the policyholder when the policy is voluntarily terminated before maturity, or when the insured person dies). Taxpayers could transfer policies with low cash surrender value (CSV) to closely held corporations in exchange for a promissory note equal to the Fair Market Value (FMV) of the policy.

A tax-free amount could then be extracted from the transaction. For example, let's say Simon owns a life insurance policy and all the shares of Holdco, and both the cash surrender value and adjusted cost base of the policy is $1,000, while the FMV is $10,000.

Simon transfers the policy to Holdco. The proceeds on the transfer are deemed the CSV — $1,000. Holdco pays Simon through a promissory note equal to the FMV of the policy — $10,000. Over time, Holdco pays back the promissory note to Simon, tax free. Now, however, the federal budget has eliminated this advantage.

Under the new rules, when a life insurance policy is transferred to a closely held corporation, there will now be deemed proceeds to the transferor equal to the FMV. In our example, Simon receives a taxable gain of $9,000 ($10,000 FMV minus the $1,000 adjusted cost base). The new rules took effect on March 21, 2016.

The other major change concerns how a death benefit is credited to the capital dividend account.

The old rules allowed a life insurance policy to be purchased by one corporation while the

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When serious injury doesn't pass threshold

Domenic Nicassio

How "serious" does a "serious impairment" have to be for a plaintiff to pass the threshold under s. 267.5 of the *Insurance Act*? What kind of evidence should be advanced by a plaintiff in order to establish a viable future income loss claim?

These and other questions were considered in the decision of *Ayub v. Sun* 2015 ONSC 1828. The trial took place before Justice James Diamond of Toronto and the appeal was released by the Divisional Court on Oct. 27, 2016.

The decision provides useful guidance on the pitfalls awaiting plaintiffs in their attempts to establish a threshold injury under regulation 461/96 of the *Insurance Act*.

The plaintiff, Mohammad Mohammad Ayub, had been involved in a rear-end collision on June 3, 2009. The defendant admitted liability. There was reportedly minimal damage to the vehicle. At the scene of the accident the plaintiff felt dizziness and pain. He was assisted by an ambulance, and radiological studies at a hospital confirmed that nothing was fractured.

After the 2009 accident the plaintiff developed a chronic pain condition.

The plaintiff's doctors at trial were Dr. Steven Blitzer and Dr. David Berbrayer. The defendant relied upon the medical opinion of Dr. Michael Devlin.

Remarkably, the defendant at trial *agreed* that the plaintiff's condition was permanent, and all three experts agreed that the plaintiff was suffering from chronic pain in some form or other.

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The defendant conceded that the plaintiff had adduced evidence of impaired functions as a result of headaches and back pain "with consequential difficulties associated with movement, sleep and mood."

The trial took place the week of March 12, 2015, and a jury awarded the plaintiff $25,000 for general damages and $5,000 for future health care expenses. Nothing was awarded for income loss due inter alia to the fact that there was insufficient evidence on the issue for the jury to consider.

The jury deliberated and Justice Diamond heard the threshold motion. He dismissed the action on the basis that the threshold had not been met.

A determinative issue was the *severity* of the plaintiff's impairment and the effect on the plaintiff's lifestyle.

The plaintiff's evidence of his pre-accident daily routine was described as "unspecified and vague."

Justice Diamond found one piece of consistent evidence for the pre-and post-collision time periods, and that was the plaintiff's attendance at an ESL course: "To the extent that the ESL course could constitute 'regular training' there was *no evidence that the plaintiff's chronic pain interfered with his ability to continue and eventually complete that training*" [emphasis added].

> **Whatever 'serious impairment' means for the purpose of a threshold motion, it cannot mean that a plaintiff continues with an activity without substantial interference or as might have occurred in this case, without any interference at all.**
>
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Furthermore, there was evidence that the plaintiff continued albeit with pain, to participate in household activities.

Ultimately the plaintiff failed to establish that his pain substantially interfered with his activities.

The Divisional Court found no error of law or fact in the conclusion. The jury's minimal award was rendered irrelevant in light of the threshold decision.

Whatever "serious impairment" means for the purpose of a threshold motion, it cannot mean that a plaintiff continues with an activity without substantial interference or as might have occurred in this case, without any interference at all.

The decision also serves as a useful reminder that asserting a loss of income claim is not always the same as proving one.

One of the grounds of appeal concerned Justice Diamond's decision not to put the income loss issue to the jury. The plaintiff's statement of claim contained a reference to "pecuniary damages" up to the present the "full particulars" of which were not known when issued.

The plaintiff was born in Afghanistan and came to Canada in 2007. Prior to arriving in Canada the plaintiff had worked for nine years in Russia. His plan was to improve his English by enrolling in the ESL course in 2007 and then possibly obtain employment in Canada. He received social assistance while living in Canada and never secured employment.

Justice Diamond found no evidence of any employment history on the part of the plaintiff in Canada, and there was "little to no evidence" of his employment history in Russia.

While the Divisional Court agreed that a lesser standard of proof would apply to future income loss, it was ultimately persuaded that there was insufficient evidence at the trial to justify putting the question of income loss before the jury: "The trial judge correctly identified that it would be problematic to require a jury to try and calculate the income loss *without evidence before them of income or expectation of income*" [emphasis added].

According to the Divisional Court, there was no evidence led at trial about the plaintiff's employment prospects, the type of work he sought to obtain, or the skills that he had to get a job in Canada. The only evidence he had about the job search was a training session he attended at Tim Hortons, but no details were provided about what the training entailed, the nature of the position, or how much such a job would have paid.

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Rules: Death benefit must be reduced by total adjusted cost base of policy

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beneficiary of the policy could be another corporation. The "owner" corporation would carry the adjusted cost base of the policy, but the other corporation would receive the entire death benefit as the beneficiary. Consequently, the full death benefit would be credited to the capital dividend account since the adjusted cost base to the beneficiary corporation was nil.

The new rules eliminate this advantage as well by providing that the death benefit received must be reduced by the total adjusted cost base of the policy — even if the adjusted cost base is held by the policyholder corporation and the death benefit is received by a beneficiary who is a completely different entity.

For example, the owner of the policy on the life of Simon is Holdco and the adjusted cost base of the policy is $1,000. Holdco and Simon's widow both own shares of Opco. Opco is the beneficiary of the policy and receives the $10,000 death benefit. There is no adjusted cost base with respect to the policy in Opco, so under the old rules, on receiving the death benefit Opco can add $10,000 to its capital dividend account, which can be paid out tax-free to Simon's widow.

But with the new rules the total Opco can add to the capital dividend account is $9,000 ($10,000 death benefit minus the $1,000 adjusted cost base to Holdco). The new rules on death benefits took effect on March 21.

An added wrinkle is that new rules will directly affect how the adjusted cost base of a policy is calculated. The adjusted cost base is calculated as the sum of premiums paid for the insurance less the accumulation of the net cost of pure insurance. Generally, the adjusted cost base of a policy increases over time and eventually decreases until it reaches zero. New rules aim to reduce the net cost of pure insurance through changes in how it is calculated. This means the adjusted cost base now increases at a higher rate and takes a longer amount of time to reach zero.

The result? You pay more tax. The best advice is to consult a good tax lawyer with regard to life insurance policies.

Robert Kepes is a founder and Jennifer Leve is an associate with Morris Kepes Winters LLP, a Toronto-based tax law boutique.