The Institute for Advanced Financial Education

COMMENT

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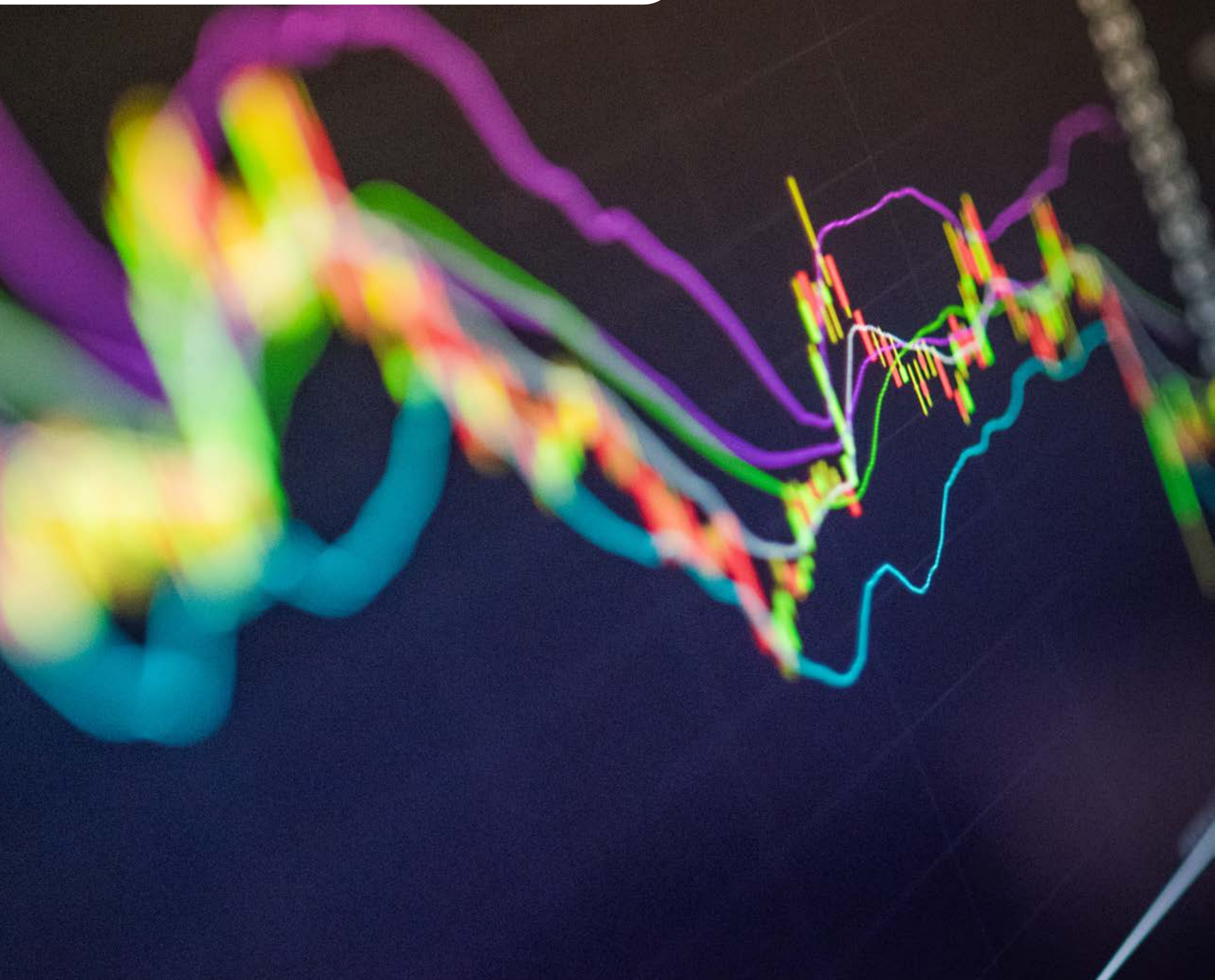
A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.



Estate Freeze and Refreeze in an Economic Downturn

Business owners typically consider tax planning at a time when their businesses are flourishing and their wealth is increasing. However, the COVID-19 pandemic — and the ensuing economic downturn — may also provide planning opportunities that can improve their tax situation. Let's discuss how business owners may achieve tax savings in the long run by implementing an estate freeze or a refreeze during an economic downturn, as well as the insurance opportunities they present.

ESTATE FREEZE

On death, business owners are deemed to have disposed of their private company shares at fair market value (FMV). The capital gains realized on the deemed disposition are taxable on their final returns. Thus, as the value of their businesses grows throughout their lifetime, the accrued gains in their shares can be substantial, which may result in significant taxes payable at death.

An estate freeze can cap a business owner's tax liability at death by freezing the value of his shares at today's FMV. In a typical scenario, the transaction involves a tax-deferred exchange of participating common shares for fixed value preferred shares. The fixed redemption value of the preferred shares will equal the FMV of the common shares at the time of the freeze. Assuming the preferred shares are held until death, this fixed redemption value will be the value on which the tax liability on the deemed disposition will be calculated. As a result, logically it follows that the lower the fixed redemption value of the shares, the lower the tax liability at death.

As mentioned, the fixed redemption value of the preferred shares would generally equal the FMV of the common shares exchanged. It should not be arbitrarily understated for purposes of reducing the associated tax liability. In fact, it is important that a professional valuation of the shares be obtained and a price-adjustment clause be included in the relevant agreements to avoid potential tax issues. However, where the value of the business has declined due to an economic downturn and it is expected that the business value will recover once the economic situation improves, this temporary reduction in business value presents a great planning opportunity to undertake an estate freeze.

For example, let us assume Mr. A wholly owns A Co. common shares. The value of these shares before the economic downturn was $5 million. The adjusted cost base (ACB) of the shares are nominal. As a result of the economic downturn caused by the pandemic, the value of the business declines to $3 million. However, Mr. A is optimistic that the business value will return to $5 million in year 2024.

As shown in Table 1, if no estate freeze was done and Mr. A happens to die in year 2024 after the business value returns to $5 million, his capital gains tax liability at an assumed tax rate of 25% will be $1.25 million. However, had he done an estate freeze today and he dies in year 2024, his capital gains tax liability will only be $750,000. This represents a tax savings of $500,000. In addition, assuming his will needs to be probated, doing the freeze today may also reduce the probate fees (assuming Ontario probate rate) on his shares by $30,000.

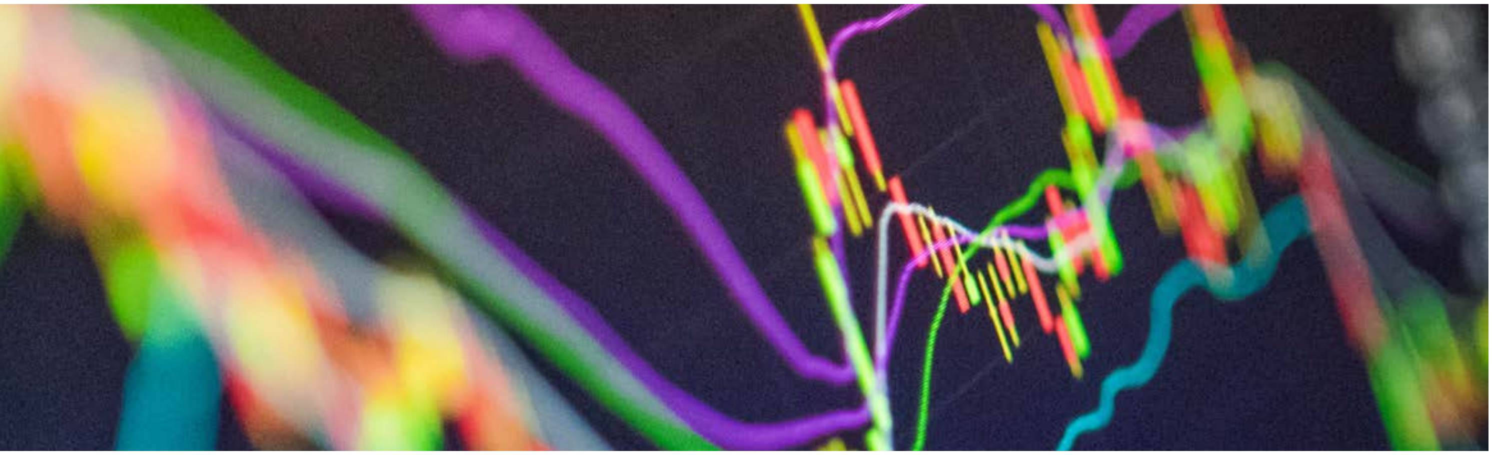


Table 1

Tax liability at death	Mr. A dies in 2024, without freeze	Mr. A dies in 2024, with freeze
Deemed proceeds	$5,000,000	$3,000,000
ACB	Nominal	Nominal
Capital gains	$5,000,000	$3,000,000
Tax @ 25%	$1,250,000	$750,000
Tax savings ($1.25m–$750k)		$500,000
Probate savings ($5m–$3m) x 1.5%		$30,000

An estate freeze conversation can easily lead to life insurance planning discussions. Once a freeze is done, the tax liability of the business owner is fixed and can be easily estimated. What is the business owner's plan in terms of funding this tax liability at death? What funding options are available? Life insurance is an obvious funding option and it often is the most cost-effective solution in many cases.

In addition to providing liquidity at death, life insurance may also be used in conjunction with post-mortem planning to generate tax efficiency. Let us further assume that A Co. owns a life insurance policy on Mr. A with a death benefit of $3 million and an ACB of nil at death. The credit to A Co.'s life insurance capital dividend account (CDA) will, therefore, be $3 million.

As shown in Table 2 on the next page, without life insurance and using the redemption with loss carryback post-mortem planning method, the dividend tax rate (assumed at 45%) will apply on the redemption of $3 million of preferred shares. However, where insurance planning is in place with $3 million of CDA credit available at death, the overall tax rate of the redemption with loss carryback planning can be reduced depending on how the redemption is structured (e.g., full CDA redemption, 50% solution, or spousal roll and redeem). Evidently, life insurance can help optimize the business owner's tax situation at death.

Table 2

Redemption and loss carryback – s.164(6)

	No insurance	With insurance (full CDA)	With insurance (50% solution)	With insurance (spousal roll and redeem)
FMV of shares	3,000,000	3,000,000	3,000,000	3,000,000
Less: tax on capital gains (assume tax rate of 25%)	-	375,000	-	-
Less: tax on dividend (assume tax rate of 45%)	1,350,000	-	675,000	-
Net funds to estate	**1,650,000**	**2,625,000**	**2,325,000**	**3,000,000**
Total tax as %	45.00%	12.50%	22.50%	0.00%
CDA credit remaining	-	-	1,500,000	-

REFREEZE

Some business owners may have previously done an estate freeze. If the economic downturn has significantly impacted the value of their business such that the overall value of their corporation is now less than the fixed redemption value of their freeze shares, a refreeze can be a great strategy to generate tax savings in the long run.

Consider the following example:

- Mr. B is the founder of B Co. He did an estate freeze in 2015 and received $6 million of fixed value preferred shares.
- A family trust was set up at that time to subscribe for newly issued common shares. The common shares have since grown and are worth $1 million.
- The total value of B Co., therefore, is $7 million ($6 million + $1 million).
- As a result of the economic downturn, the overall value of B Co. fell to $4 million.
- Mr. B expects the value of B Co. to return to $7 million or greater in a few years.

Preferred shareholders generally have a priority claim over common shareholders on the liquidation of a company. As a result, since the overall value of B Co. is now only $4 million, Mr. B's preferred shares are now worth only $4 million, despite having a fixed redemption value of $6 million. The existing common shares owned by the family trust would have nominal value. Mr. B may consider doing a refreeze to achieve tax savings.

A refreeze essentially involves converting the existing freeze shares into a new class of freeze shares, generally on a tax-deferred basis. This resets the fixed redemption value of the freeze shares to the current lower FMV. This planning may provide several tax benefits for Mr. B:

1. Lower capital gains tax at death

Resetting the freeze share value to $4 million from $6 million will reduce the fixed redemption value of Mr. B's preferred shares. Lower share value means lower tax liability at death, which creates tax savings.

2. Income splitting

Assuming Mr. B has been using the family trust structure to sprinkle dividends with his family members where the Tax on Split Income (TOSI) rules do not apply, such dividend payments may no longer be allowed if the value of his existing preferred shares is underwater. The reason for that is because the rights and restrictions of preferred shares generally require that dividends on common shares cannot be declared if the payment of dividends would reduce the value of the outstanding preferred shares.

By doing a refreeze to reset the preferred share value at today's lower value such that the preferred shares are no longer underwater, future profit may continue to

Table 3

Tax liability at death	Value recovered, without refreeze	Value recovered, with refreeze
Deemed proceeds	$6,000,000	$4,000,000
ACB	Nominal	Nominal
Capital gains	$6,000,000	$4,000,000
Tax @ 25%	$1,500,000	$1,000,000
Tax savings ($1.5m–$1m)		$500,000
Probate savings ($6m–$4m) x 1.5%		$30,000

be paid to common shareholders by way of dividends (subject to TOSI). As such, a refreeze may help facilitate existing income splitting planning.

3. Extending the 21-year deemed disposition date of a family trust

The existing family trust was set up in 2015. Its 21-year deemed disposition date would be around year 2036. Since the common shares owned by the 2015 family trust currently have nominal value, this family trust, together with the common shares it owns, can be wound up. A new 2020 family trust can be set up as a part of the refreeze to subscribe for newly issued common shares. This 2020 family trust would have its 21-year deemed disposition mark in year 2041, which is five years later than that of the 2015 family trust. This provides more tax deferral and more time for Mr. B to decide how to deal with the trust-owned shares.

With respect to final tax liability, Table 3 shows the tax and probate savings that may be achieved if Mr. B does a refreeze today at $4 million. As shown, a refreeze may result in $500,000 of tax savings and $30,000 in probate fee savings.

In terms of insurance opportunities, where the business owner has not considered insurance planning previously, a refreeze discussion may also lead to insurance planning opportunities similar to those discussed under the estate freeze.

Where insurance planning has been incorporated previously, a refreeze may reduce the amount of insurance protection needed in terms of the liquidity needs at death. An updated review of the business owner's insurance needs can help determine if any excess coverage can be used for other estate planning objectives, or if the coverage can be reduced to result in cost savings. More importantly, as the business recovers in value in the future, more growth will accrue to the common shareholders that are usually the next generation or a family trust for the benefit of the next generation. As such, the insurance needs of the next generation should be reviewed to determine if there is adequate insurance protection in place to address their liquidity and estate planning needs.

While an economic downturn may bring about financial challenges to many businesses, it may also provide some great tax planning opportunities. Helping business owner clients recognize the planning opportunities can help increase insurance advisors' value proposition, as well as lead to more insurance planning opportunities. ©

Written by Carey Lee, CPA, CA, Vancouver-based assistant vice-president, Regional Tax, Retirement & Estate Planning Services, Individual Insurance, at Manulife Financial.

The Valuation of Corporate-owned Life Insurance on the Death of a Shareholder

The valuation of life insurance policies for the purposes of Canadian tax law is subject to a confusing set of rules and interpretations. In some instances, specific provisions in the *Income Tax Act* (the Act) apply, and in others, more general provisions may or may not apply. Regardless, these rules are subject to the interpretation of the Canada Revenue Agency (CRA), whose pronouncements can be inconsistent and difficult to reconcile.

Let's focus on the rules that apply where a private corporation owns a policy on the life of a deceased shareholder. In this case, subsection 70(5.3) of the Act provides relatively clear rules. Predictably, there are circumstances that fall outside of the specific wording of this provision and which should be identified.

1. General Application of Subsection 70(5.3) on a Shareholder's Death

Section 70 of the Act contains a lengthy list of provisions dealing with a taxpayer's death. In the case of capital property, such as shares of a private corporation, a disposition is deemed to occur immediately before the shareholder's death. To the extent that the shares' fair market value (FMV) at that time exceeds their adjusted cost base (ACB), a capital gain will be recognized in the deceased's terminal return. Similarly, a capital loss will be realized where the shares' ACB is greater than FMV.

As readers will be aware, the above is subject to exceptions that apply where shares are transferred to a surviving spouse or common-law partner, or to a qualifying trust for such person. In that case there is a "rollover" that defers the realization of any capital gain or loss to the death of the surviving spouse or partner.

Subsection 70(5.3) specifically deals with the valuation of shares deemed to have been disposed of on death, where the corporation owned insurance on the life of the deceased or on the life of an individual with whom the deceased did not deal at arm's length at the time the policy was issued (such as the deceased's spouse, sibling, or child). Where the subsection applies, the FMV of the shares will be determined as though the FMV of the relevant policy was its cash surrender value (CSV). For these purposes, policy loans are essentially ignored, and are therefore included in the CSV. Unpaid dividends and the CSV of paid-up additions are also included.

These rules were introduced following the 1977 Federal Court of Appeal decision in the case of *Mastronardi v. The Queen*. In that case, the taxpayer successfully challenged the CRA's position that the death benefit under a corporate-owned term insurance policy should be considered in valuing the deceased's shares.
The Court held that no insurance proceeds were payable "immediately before death," and that as a result the amount of the proceeds should not be considered in valuing the deceased's shares under the deemed disposition rules. Subsection 70(5.3) essentially codifies the *Mastronardi* decision, although with certain limitations that will be addressed below.

2. Technical and Planning Considerations

a) Limitations on the Scope of Subsection 70(5.3)

As described above, subsection 70(5.3) applies to policies on the life of the deceased and certain non-arm's length parties. It does not, however, apply in a number of other circumstances. Let's look at three examples where the subsection would not apply:

Example 1

Assume that A is the sole shareholder of a corporation that owns insurance on A's life. The corporation also owns a "key person" policy on B, a person who is a key employee but not a shareholder, and with whom A deals at arm's length. On A's death, subsection 70(5.3) will apply in valuing the policy on A's life. It will not, however, apply in determining the value of the policy on B's life. Therefore, the FMV of A's shares immediately before death will include the CSV (if any) of the policy on A's life, but the policy on B's life, as it impacts the value of A's shares, will be valued under general valuation principles (see discussion in Example 3).

Example 2

The inclusion of insurance on the life of non-arm's length parties within subsection 70(5.3) applies only where that relationship existed at the time the policy on the deceased's life was issued. There could be (admittedly rare) circumstances where there was an arm's length relationship when the policy was issued, but the parties became non-arm's length at a later date. For example, if A and B in the above example were originally arm's length parties, but were married after the policy on A's life was issued, subsection 70(5.3) would still not apply in valuing the policy on B's life at the time of A's death. (Any resulting increase in A's share value would not be of concern, however, if A's shares were transferred to B on a tax-deferred basis following A's death.)

Example 3

Assume that three arm's length shareholders, X, Y, and Z, are equal shareholders of a corporation. The corporation acquired insurance on all three lives for the purposes of buy-sell funding. Assuming X was the first to die, subsection 70(5.3) would theoretically apply regarding the corporate-owned policy on his life, but not regarding the policies on his arm's length co-shareholders, Y and Z. This may, however, be simply an academic point, as the valuation formula under the shareholders agreement would likely override subsection 70(5.3), i.e., the FMV of the deceased's shares would be based upon a binding agreement that, in most cases, should specifically exclude life insurance proceeds from the purchase price.

b) Valuation where 70(5.3) Does Not Apply

Where subsection 70(5.3) does not apply, an insurance policy would be valued on general valuation principles. These would presumably apply in valuing the policy on B's life, at the time of A's death, in Example 1. The valuation would likely require the services of an independent actuary. The CRA's views on the valuation of life insurance policies are provided in Information Circular IC 89-3 and would be important in any valuation performed by an independent actuary. The key factors identified in the circular are as follows:

- the CSV of the policy;
- the loan value of the policy;
- the face value of the policy;
- the state of health of the life insured and his or her life expectancy;
- the policy's conversion privileges;
- replacement value; and
- the perceived imminence of death.

c) CRA Commentary on Shared Ownership

Under a typical shared ownership agreement, ownership of a life insurance policy is shared between one party who requires the life insurance coverage (typically a corporation) and another who has longer term needs (typically the shareholder). The costs and benefits of the policy are shared by the parties in accordance with a shared ownership agreement. Generally, the death benefit owner (the corporation) will pay an amount reflecting insurance charges under the policy, and will designate a beneficiary for the policy's face amount. Deposits to the policy's investment accounts will be made by the cash value owner (the shareholder), who will designate a beneficiary for that portion of the policy.

In a recent roundtable presented by the Conference for Advanced Life Underwriting, the CRA was asked to comment on the potential application of subsection 70(5.3) in a shared ownership arrangement. The question concerned whether the policy's CSV would be included in the value of shares owned by a deceased shareholder where, under the shared ownership arrangement, the CSV had been owned by the deceased.

In its response, the CRA noted that subsection 70(5.3) does not specifically refer to policies where there is more than one ownership interest, and was unable to state definitively that the value of the corporation's interest would be nil. It appears that the CRA is concerned about certain situations where the corporation is "quick paying" premiums and, as a consequence, benefiting or subsidizing the shareholder. In its response, the CRA stated that "the terms and conditions of the shared ownership arrangement, the specific life insurance contract and all other related agreements which may form part of the particular arrangement and the particular facts at the given time would have to be considered. …"

It is hoped that the corporation's interest in the policy will be valued at nil for the purposes of subsection 70(5.3), in an arrangement where the corporation's share of the premiums more accurately reflects the actual annual cost of insurance, and does not benefit the shareholder in any way. In this regard, shared ownership arrangements will be considered on a case-by-case basis and need to be structured carefully. ©

Written by Glenn Stephens, LLP, TEP, FEA, vice-president, planning services at PPI Advisory. He can be reached at gstephens@ppi.ca.

DRIVEN TO DISTRACTION

Thanks to a clampdown on drunk driving, more use of seatbelts, and cars equipped with airbags and the technology to help avoid accidents, the number of deaths due to motor vehicle accidents has decreased over the past few decades. However, the risks of mortality and morbidity related to drunk driving are still essential risk factors to assess when underwriting insurance applicants.

Transport Canada reported more than 160,000 car accidents each year on average over the last decade in Canada (2008–2018), with 108,000 resulting in personal injury in 2018. Although the fatality rate (per 10,000 registered motor vehicles) dropped from 1.62 to 0.77 in 2018, that's still an average of eight fatalities per day. Victims in the 65 and up age group are most likely to die, followed by those aged 25 through 34, who are also more likely to be injured.[1]

According to 2017 data out of the United States from Centers for Disease Control and Prevention, 45% of U.S. deaths in the 20 to 24 age group were attributable to accidents, and primarily motor vehicle accidents.[2] Inexperience, combined with a youthful sense of being invincible, are two contributing factors behind these statistics.

Young males tend to drive faster and typically have less experience in avoiding accidents. Alcohol is often a factor, as is distracted driving. According to Statistics Canada, in 2015, 27% of deaths on Canadian roads resulted from speeding, and distracted driving increased the risk of an accident by 500%. Even with efforts to reduce impaired driving, 40% of drivers killed in a car crash in 2008 consumed alcohol before getting behind the wheel.[3]

The other age group of concern is those 65 and older. Here, driving too slowly is the problem. They may have slower reflexes and decreased confidence. Poor eyesight, particularly with night driving, may contribute, and they may also be on prescription medications that can impede their ability to react quickly.

For this reason, when underwriting for motor vehicle accident risk, the underwriter will look at several risk factors and pay particular attention to those under 30 and those 65 and older.

For the younger applicant under age 30, underwriters will note the applicant's occupation and consider whether it involves a significant amount of driving. Experience has shown that a poor driving history is a good indicator of an individual's future driving skills, so an applicant with a history of traffic violations will be more likely to have accidents in the future. Other behaviour patterns that suggest the applicant may have poor judgment include driving without a seatbelt, while using a cell phone, or without automobile insurance.

Underwriters will also consider the applicant's participation in hazardous sports or aviation, which may show a tendency for thrill-seeking and speeding. They'll also check whether there is past criminal history that would highlight a risk taker.

Since alcohol and drugs are involved in approximately half of all fatal auto accidents involving young adults under age 30, any concern about alcohol overuse or drug use, including cannabis, would be a significant red flag. An applicant with a charge of driving under the influence (DUI) with abnormal laboratory findings of alcohol overuse could be declined, as would a fairly recent history of more than one DUI.

The underwriter will be wary of habitual offenders, as frequency and severity of the offence are known risk indicators. For example, a repeat offender who drives 50 km per hour over the speed limit will be assessed as carrying more risk than someone who speeds 30 km per hour above.

For seniors over age 65, driving history remains a consideration, but the underwriter will focus more attention on how the applicant manages daily living activities, along with any medical impairments they might have, and any prescription medications being taken. Identifying those seniors who should not be on the road any longer may be a challenge for families and physicians, but this is extremely important as they pose the greatest risk for motor vehicle accidents.

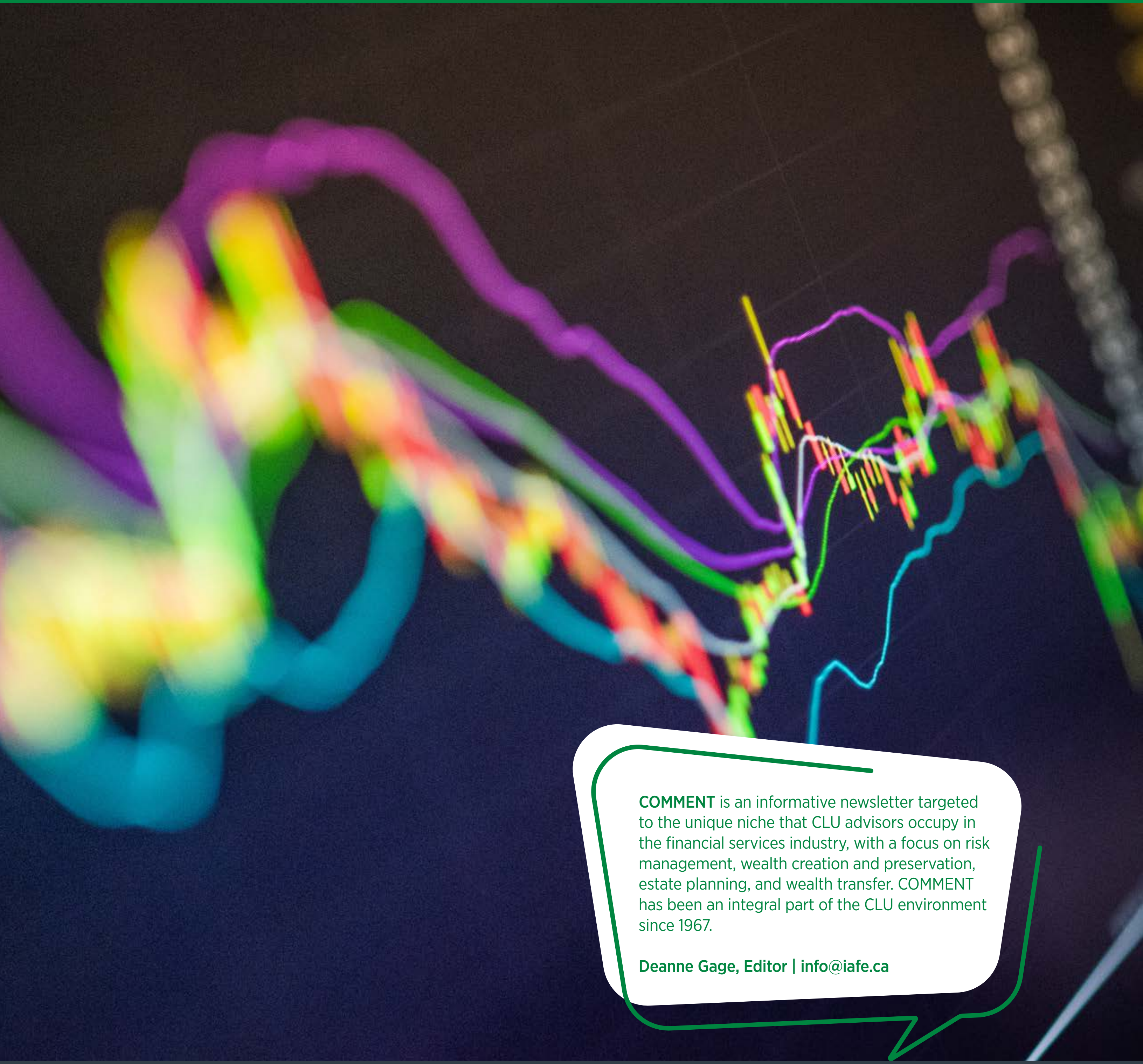
At all ages, underwriters will require motor vehicle reports whenever there is significant driving history, as it is the best tool available to assess driving risk. If there are concerns about alcohol or the applicant's ability to continue to drive, a blood profile and potentially a doctor's report may also be needed. A habitual offender may be declined coverage or offered a substandard policy, depending on the severity of the past infractions, recency, frequency, and any other contributing risk factors that may be present. ©

Written by Carol Neuss, assistant vice-president and chief underwriter, insurance new business, individual customer for The Canada Life Assurance Company.

[1] *Source: Statistics Canada, CANSIM, Table 405-0004. From 1999 the licensed driver data were provided by each jurisdiction:* *https://tc.canada.ca/en/canadian-motor-vehicle-traffic-collision-statistics-2018*

[2] *Source:* Verywell Health *https://www.verywellhealth.com/top-causes-of-death-for-ages-15-24-2223960*

[3] *Source: Canadian Association of Chiefs of Police quoting Statistics Canada and Transport Canada data: https://www.cacp.ca/index.html?asst_id=1626*



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Deanne Gage, Editor | info@iafe.ca