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LIFE INSURANCE POLICY: HOW TO EXTRACT FUNDS FROM A CORPORATION WITH NO TAX IMPACT

Luc Pariseau *with the collaboration of Martin Bédard, articling student*

Individual shareholders who wish to withdraw funds from a corporation can face some tax challenges that are sometimes difficult to overcome. Nevertheless, there are various ways of achieving this objective that limit or eliminate the negative tax consequences to the shareholder and the corporation, provided certain conditions are complied with. The transfer of a life insurance policy by an individual shareholder to a corporation where the two are in a non-arm's length relationship is often an effective way of accomplishing this.

The technique is simple. The individual transfers his policy to his corporation and receives a consideration equal to the fair market value of the policy, as determined by an actuary. The consideration paid by the corporation may be in the form of money or a promissory note that will be paid when the corporation has the necessary cash available. By operation of the ITA, the proceeds of disposition are deemed to be equal to the cash surrender value of the policy transferred at the time of the disposition.[1]

The shareholder is then taxed on the difference between the cash surrender value of the policy and its adjusted cost base, and the resulting gain, if any, is considered to be income from property and not a capital gain.[2] Assuming that the cash surrender value of the policy is low and that its fair market value is high, the shareholder will benefit from a significant disbursement of funds with little or no negative tax impact.

The fair market value of a policy will be higher than its cash surrender value, for instance, where the insured's health condition has deteriorated since he or she took out the policy. This will also be the case where the theoretical premium for a comparable policy would be higher than that paid for the policy in question for financial reasons attributable to the type of policy purchased or to changes in

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pricing.

As for the corporation, it ends up making a non-deductible outlay of funds and acquiring an interest in an insurance policy with an adjusted cost base equal to its cash surrender value. Thus, upon the death of the shareholder, in addition to receiving the insurance proceeds, the corporation will also benefit from an increase in its capital dividend account equal to the indemnity received, less the adjusted cost base of the policy.[3]

The Canada Revenue Agency acknowledges the validity of this type of planning, but seems to be uncomfortable with the result.[4] It has submitted this issue to the Department of Finance which has indicated that it is studying the issue. However, no amendment has been made to the statute to date, more than 10 years after the issue was raised for the first time in 2002.

In addition, there are certain advantages to the corporation holding the insurance policy and paying the premiums, particularly the fact that the after-tax cost of the premiums is often lower to the corporation than it would be to the shareholder.

The foregoing analysis is obviously general in nature and a more detailed assessment is advisable for any individual who is in a position to transfer a personally owned policy to a corporation.

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[1] Subsection 148(7) of the *Income Tax Act* ("ITA").

[2] Subsection 148(1) and paragraph 56(1)(j) ITA.

[3] Subsection 89(1) "capital dividend account" d) ITA.

[4] CRA, Technical Interpretation 2002-0127455, "Non arm's length disposition" (May 7, 2002); CRA, Technical Interpretation 2003-0040145, "Transfert d'une police d'assurance-vie" (October 6, 2003); ARC, Technical Interpretation 2008-0303971E5, "Transfer of a life insurance policy" (May 27, 2009).

CONSTRUCTIVE DISMISSAL ANALYZED IN THE CONTEXT OF A BUSINESS ACQUISITION
Guy Lavoie and Élodie Brunet *with the collaboration of Brittany Carson, articling student*

In the case of *St-Hilaire* c. *Nexxlink inc.*[1] the Court of Appeal of Québec analyzed the concept of "constructive dismissal" in the specific context of a business acquisition.

In this case, Nexxlink was the subject of an acquisition that resulted in a series of changes to the business, some of which affected the employment conditions of Mr. St-Hilaire. Believing that this had resulted in substantial changes to the essential conditions of his employment contract, Mr. St-Hilaire left his employment shortly after the transaction, alleging that he had been constructively dismissed. He claimed $525,000 in damages from Nexxlink.

The Court of Appeal affirmed the decision of the Superior Court, holding that Mr. St-Hilaire had not been constructively dismissed.

According to the criteria laid down by the Supreme Court of Canada, constructive dismissal involves [translation] "1) a unilateral decision by the employer, 2) a substantial change or changes to the essential terms of the employment contract, 3) the employee's refusal of the changes, and 4) the

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employee's departure." These criteria are assessed from the perspective of a reasonable person placed in the same situation.[3]

In the context of the transaction in this case, the change in the title of Mr. St-Hilaire's position from *vice-president, business development to vice-president, infrastructure equipment sales* did not amount to a substantial change in his employment conditions nor a demotion, but rather a change in the organization of the business, which was within the management rights of Nexxlink.

With respect to the changes alleged by Mr. St-Hilaire to his responsibilities and target market, these were only fears. In the context of a business acquisition, some of the senior executives' duties may be changed or clarifi ed over time: [translation] "a period of uncertainty or adjustment is entirely foreseeable". According to the Court, a reasonable person placed in the same context as Mr. St-Hilaire could have foreseen that he would have retained his client accounts, and that various opportunities could be expected within the new business.

With regard to Mr. St-Hilaire's compensation, it consisted primarily of a base salary of $170,000, a $40,000 bonus plan, and 20,000 stock options at the time he started his employment.

Contrary to Mr. St-Hilaire's allegations, the Court found that the criteria for awarding the annual bonus had not been substantially changed. Moreover, even if this had been the case, his employment contract expressly stated that the bonus plan could be changed simply upon the approval of the board of directors. As for the cancellation of the stock options, even if this could be considered to be a reduction in Mr. St-Hilaire's compensation, he never complained about it before leaving the company. According to the Court, Mr. St-Hilaire undoubtedly did not feel that this was an essential condition.

In conclusion, the Court of Appeal found that Mr. St-Hilaire was aware of the role that was reserved for him in the new business. The structure he complained of was temporary and uncertain. In the context of this transaction, the allegations of constructive dismissal were ill founded.

The interest of this decision lies in the fact that it relativizes the concept of constructive dismissal in the specific context of a business acquisition, in addition to reiterating the principle that the structure of a business is not bound to remain static.

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[1] 2012 QCCA 1513 (C.A.)(affi rming 2010 QCCS 2276 (S.C.)).

[2] *Id*., para. 29, citing *Farber* v. *Royal Trust Co.*, [1997] 1 S.C.R. 846 (hereinafter "*Farber*").

[3] *Farber*, para. 26.

THE RIGHT OF WITHDRAWAL, A CONTROLLED FORM OF CONTRACTUAL FREEDOM
Catherine Méthot

The right of withdrawal, also referred to as an "opting out" clause, is the right given contractually or by law to a party to withdraw from a transaction without justifi cation prior to it being actually entered into. Although the withdrawal clause may procure a high degree of freedom, one cannot invoke it in a cavalier manner. Indeed, a withdrawal clause cannot be used in a malicious or abusive manner, nor can it run against the requirements of good faith. Furthermore, to be valid and effective, a withdrawal clause must be enforceable and explicit.

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The Court of Appeal of Québec recently reminded us of these principles in the case of *London* v. *Kyriacou*.[1] In this case, the owners of a day-care centre (the "**Sellers**") accepted from Mrs. Kyriacou and Mrs. Teologou (the "**Purchasers**") an offer to purchase the daycare centre. The sale was initially scheduled to take place on September 29, 2006. This date was thereafter postponed several times and the terms of the offer were also amended on several occasions as the months went by. Among other things, the parties agreed to increase the sale price by $150,000.00 conditionally to the day-care centre being granted a government subsidy within 15 months from the date of the sale. As soon as autumn 2006, the Sellers introduced the Purchasers to the parents of the children attending the day-care centre as being the new owners of the facility from January 2007. In May 2007, the Purchasers began operating the day-care centre and acting like true owners, particularly by having repairs made at their own cost and establishing a new educational program. From May 2007, the parties exchanged several draft sale agreements and the transaction was to take place in August 2007. However, on August 10, 2007, following receipt of a letter from government authorities confi rming that the day-care centre would be subsidized beginning in March 2008, the Sellers notifi ed the Purchasers that they were withdrawing from the negotiations. They also changed the locks of the day-care centre and denied access thereof to the Purchasers.

The Purchasers brought a motion for the transfer of title before the Superior Court of Québec to force the Sellers to carry out the transaction. The Sellers opposed the motion, among other things alleging that the initial offer to purchase included an opting-out clause, which they were entitled to rely upon. The clause read as follows: "After due diligence is said and done and all conditions have been agreed upon, if one of the parties' purchaser or vendor refuse to go ahead the other will be liable for professional fees occurred."

In the first instance, the Superior Court refused to apply the clause because the Sellers had acted in bad faith all along the negotiation process, that further, the clause was not explicit and that had it been explicit, the Sellers, by their actions (particularly by encouraging the respondents to operate the day-care centre and the substance of the discussions on the sale agreement) waived its application. The Superior Court found from the evidence that all the conditions mentioned in the original offer had been satisfied and that there had been an agreement on all the new elements raised thereafter by the Sellers. In short, the terms of the transaction had been agreed upon by the parties and it only remained to make it offi cial by executing an agreement. The Superior Court therefore ordered the parties to sign the agreement and the Court of Appeal affirmed that decision.

Although including an opting-out clause in a contract or a letter of offer may constitute a very attractive strategy, the decision summarized in this bulletin articulates the importance of carefully drafting it and demonstrates that one is better to consult a professional before relying on it.

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[1] 2013 QCCA 37.

TRANSFERS OF RESIDENCES INVOLVING A SPOUSAL TESTAMENTARY TRUST
Diana Darilus

The sale of a house by a spousal testamentary trust and the purchase of a new residence in replacement of the former may result in adverse tax consequences if all required precautions are not taken prior to the fact.

EXEMPTION FOR PRINCIPAL RESIDENCE

When a spousal testamentary trust gains possession of a house following the death of a taxpayer and thereafter wishes to dispose of it, the availability of the principal residence exemption to reduce

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the taxable capital gain resulting from the transfer must be ascertained.

Furthermore, the tax act[1] provides for certain presumptions when a taxpayer disposed of a house in favour of a spousal testamentary trust through a tax rollover upon death so the trust can benefit from the principal residence exemption for the years during which the deceased taxpayer owned the house.

Generally a spousal testamentary trust may benefit from the principal residence exemption upon the sale of the house for all the years during which the deceased taxpayer or the trust itself owned it, to the extent that several conditions are met.

One of these conditions is that when the trust was the owner of the residence, the residence must have been ordinarily inhabited by a *specified beneficiary*, by the spouse or common-law partner or the former spouse or common-law partner of such beneficiary or a child of such beneficiary. *A specified beneficiary* generally means any person benefi cially interested in the trust who ordinarily inhabited the housing unit (or has a spouse or common-law partner or former spouse or common-law partner or a child who ordinarily inhabited the housing unit).

Furthermore, prior to designating the house as principal residence for the years of ownership by the deceased taxpayer while he or she was living or by the trust itself, the trust must also ascertain that no *principal residence* designation on another property has been made in respect of these years, neither by the deceased person or his or her family unit, nor by a specified beneficiary or his or her family unit.

MAINTENANCE OF TESTAMENTARY TRUST STATUS

In the context of a transaction for the sale and purchase of residences involving a testamentary trust, one must be careful not to jeopardize the *testamentary trust* status of this trust, which benefits from taxation at progressive rates.

Therefore, in order to retain its *testamentary trust* status, no item of property must be contributed to the trust otherwise than by an individual on or after his or her death and as a consequence thereof. The trust could then lose its *testamentary trust* status and related tax benefits if, for example, it does not deal at the fair market value when acquiring the new residence: the seller may be considered as having made a contribution equal to the excess of the fair market value of the property over the fair market value of the consideration paid by the trust.

Subject to certain exceptions, the *testamentary trust* status of the trust may also be lost if the trust incurs a debt or any other obligation owed to, or guaranteed by, a beneficiary of the trust (for example, the spouse of the deceased person) or another person with whom a beneficiary of the trust does not deal at arm's length.

CONCLUSION

The tax consequences of transactions involving real property transferred by or to a spousal testamentary trust should always be carefully reviewed beforehand in order to avoid unpleasant surprises.

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[1] *Income Tax Act.*

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