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COLLATERAL INSURANCE ASSIGNMENTS AND THE BACK-TO-BACK SHAREHOLDER LOAN RULES

WESTWARD ADVISORS

OVERVIEW

During the 2017 PPI Advisory National Seminars, Chris Ireland discussed the changes to the back-to-back shareholder loan rules. PPI has prepared an executive summary of the rules and why they should not apply to the collateral loan facilities offered by RBC Insurance, iA and Scotiabank.

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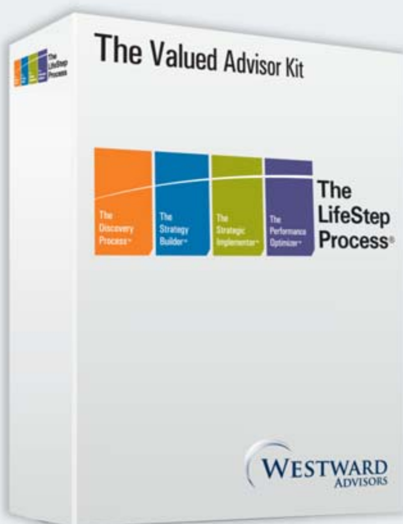

The 2016 Federal Budget expanded the back-to-back loan rules to capture situations where the shareholder loan rules in subsection 15(2) of the Income Tax Act ("Act") have been avoided by inserting an intermediary (such as a bank or other lending institution) between a corporation and its shareholder. In these situations, the corporation deposits funds with the intermediary with the intent that the intermediary lend funds to the shareholder. While a collateral assignment of corporate-owned life insurance to secure a shareholder's borrowings should not fall within this rule, it could be caught under another provision dealing with "specified rights" granted in respect of property (such as a collateral assignment of a policy). However, for the typical situation where corporate-owned life insurance is assigned as collateral security for a personal shareholder borrowing, the specified right rules should not apply if the proceeds from the collaterally assigned policy are first applied to reduce the shareholder's borrowing.

BACK-TO-BACK RULES

Background - Subsection 15(2) is designed to prevent a shareholder, or a person connected with a shareholder, from taking funds out of the corporation on a tax-free basis. If the rules apply, the amount of the loan to the shareholder is included in the shareholder's income unless the loan is repaid within one year after the end of the tax year in which the loan was made. Even though the loan repayment is deferred, the shareholder has to pay a deemed interest benefit under subsection 80.4(2) for the period the loan was outstanding.

The new rules - The provisions dealing with the back-to-back rules are contained in subsections 15(2.16) to 15(2.192) of the Act and became law in December 2016. If the rules are met, the shareholder is deemed to be indebted to the corporation, and not the intermediary, and the rules in subsection 15(2) apply. The provision of the back-to-back rules that are of concern where corporate owned life insurance is used as collateral security are the "specified right" rules. To determine what is a specified right, the definition used in another section of the Act must be reviewed. Because of this cross-reference, there is some uncertainty as to whether the rules could apply if the language in the security agreements (such as a loan agreement, collateral assignment agreement, guarantee agreement) could be construed to apply to any existing or future borrowings of the shareholder. However, despite this uncertainty some comfort can be obtained from the Explanatory Notes to the legislation which state that the back-to-back loan rules should not apply:

> "...if the security interest merely secures payment in respect of the shareholder debt and does not in-and-of itself provide a means for the funder to raise funds that may be used for a purpose other than to reduce an amount owing to it in respect of the shareholder debt."

Regardless of the uncertainty of the specified right definition, the definition contains an exclusion. A right will not be a specified right if:

> "...it can be established by the taxpayer that all of the proceeds (net of costs, if any) received, or that would be received, from exercising the right must first be applied to reduce an amount described in subparagraph (6)(d)(i) or (ii)..." (which is the shareholder debt).

PPI has reviewed the loan documentation for the collateral loan facilities offered by iA, RBC Insurance and Scotiabank and is satisfied that the back-to-back loan rules should not apply to these facilities. All of the facilities require that the proceeds be used to first reduce the shareholder's borrowing, regardless of whether the repayment occurs on death (mortality benefit or optional life benefit), or as the payment of a capital benefit or any other inter-vivos repayments (e.g. surrender). For collateral assignments with other institutions, it is very important that all of the loan documents be reviewed to determine whether the proceeds from exercising the security must be used first to pay down the shareholder borrowing, and whether the loan terms cover more than just the shareholder borrowing. Independent professional advice should be obtained.