

Overview of the Taxation of Corporate-Owned Segregated Funds



Introduction

When structured properly, segregated funds can be an integral part of a sound financial plan. When it comes to planning for your corporate clients, segregated funds can provide an investment opportunity that automatically includes a death benefit and maturity guarantee for the amount invested. These benefits can be especially important when your clients are looking to protect their investments with solid guarantees when markets are uncertain or volatile. This includes:

- ✓ An opportunity to participate in equity market growth
- ✓ Protection of capital
- ✓ Flexibility in managing distributions to shareholders from a tax-advantaged corporate asset.



When it comes to their corporate investments, many of your clients may be investing in GICs and other short-term investments to avoid market downside risk. Segregated funds may be an alternative option to help maximize returns and protect their capital.

Read the following guide for a brief overview of the structure and tax impact of corporate-owned segregated fund policies.

Note: it is not possible for corporate-owned segregated fund policies to be registered (i.e., taken the form of a RRSP, RRIF or TFSA). As a result, the discussion in this document strictly relates to non-registered segregated fund policy contracts.

Note

The ideas presented in this guide should be reviewed for suitability to individual circumstances. The information contained in this guide is general in nature and should not be construed as legal or tax advice. You and your clients are encouraged to seek the advice of other professionals such as legal and tax experts to ensure that the ideas presented are appropriate for the circumstances of the individual(s) and their corporations for whom this plan is being considered.

Parties to a Segregated Fund Policy

The parties to a segregated fund policy are different from traditional investment vehicles. There are also differences between the common-law and the Civil Code of Quebec. Here is a summary of the various terms:

Common-law	Civil Code	Taxation
Policy owner	Policy owner	Policy owner is deemed to be beneficiary of the segregated fund trust
Annuitant	Life Insured	Life Insured
Payee	Annuitant	Annuitant
Beneficiary	Beneficiary	Beneficiary

In order to simplify the article, we will be using only the common-law terms.

Here's a summary of the role of each of these parties, as they apply to corporate-owned segregated fund policies:

Policy Owner

This is the corporate entity which enters into and owns the segregated fund policy. The policy owner:

- is entitled to exercise any contractual provisions in the policy.
- will receive the funds at maturity of the segregated fund policy.
- will receive the tax slips issued in its name.

Also, the policy owner is able to name a successor annuitant in some segregated fund policies, in which case the policy continues until both the annuitant and successor annuitant pass away.

Annuitant

The annuitant is the person on whose life the maturity guarantees are based, how age-based transactions are measured, and upon whose death the death guarantee is payable. The annuitant can be the policy owner or another person.

In the case of corporate-owned policies, it's important to note that the annuitant must be an individual (and is typically an executive of the corporation).

The policy owner may appoint one or more successor annuitants to replace a deceased annuitant (the "primary annuitant"). The successor annuitant must be named before the death of the primary annuitant and is referred to as the "successor holder".

If a successor annuitant is still alive when the annuitant dies, the policy will continue. The death benefit will be payable upon the death of the last surviving successor annuitant. See the "Corporations" section below.

Beneficiary

This is the person(s) or entity named on the segregated fund policy to receive the death benefit. Beneficiaries are named by the policy owner and the death benefit is paid when the last surviving annuitant passes away. A beneficiary can be anyone – but in the case of a corporate owned policy, is typically the corporation to avoid potential adverse tax consequences.

A beneficiary designation is a very important feature of a segregated fund policy. When a beneficiary designation is in effect, death benefit proceeds can flow directly to the named beneficiaries upon the death of the last surviving annuitant in a very timely manner. Also, a beneficiary designation may offer an exemption from seizure by creditors in the common-law provinces during the life of the annuitant if the beneficiary falls within a prescribed family class, but naming such a beneficiary may have adverse tax consequences.

A beneficiary designation may be made at any time with a written request from the policy owner.

For more information, please refer to the "Corporations" section below.

Insurer

The insurer is the company that the corporation enters into an agreement with (under the terms of the segregated fund policy) and that backs the policy's guarantee provisions.

Corporations

A corporation can invest some of its assets into a segregated fund policy. In this case, the corporation becomes the policy owner and chooses an individual to be the annuitant. The choice of who should be the annuitant depends on whose life the maturity and death benefit guarantees should be based.

Typically, the corporation names itself as the beneficiary under the contract. Otherwise, a shareholder benefit may arise.

Annual T-3 slips will be issued by the segregated fund administrator to the corporation every calendar year (i.e., January 1st to December 31st).

Tax Reporting

A segregated fund is deemed to be a trust with a December 31st year-end for income tax purposes. As a trust, it can flow its net income out to the policy owners with the same characteristics as the income that was received. This means that if the trust realizes interest income, dividend income, net capital gains, net capital losses, or foreign business income, the trust will then be able to allocate to each policy owner their proportionate share of each type of income. The segregated fund will report to the policy owner their share of these different types of income on an annual T-3 slip for each calendar year.

Impact of a Disposition

Upon the disposition, partial disposition or maturity of a segregated fund policy, the policy owner may realize a capital gain if the proceeds of disposition are greater than their cost base of the segregated fund policy or a capital loss if the proceeds of disposition are less than their cost base. It should be noted that the fund administrator will report any resulting capital gain or capital loss to the policy owner on their annual T3 slip.

A disposition of a segregated fund policy will occur under any of the following scenarios:

- A full surrender of the policy by the policy owner for its market value
- A partial surrender (or withdrawal) of the policy by the policy owner for a portion of its market value
- The maturity of the policy for the greater of its market value and its guaranteed maturity amount
- The death of the annuitant (or upon the death of the successor annuitant, if one has been named) will trigger the maturity of the policy for the greater of its market value and its death benefit guarantee.



Any capital gain and capital loss triggered by a disposition is reported to the policy owner by the fund administrator on an annual T3 tax slip.

The following are not considered to be a disposition of a segregated fund policy:

- The death of the annuitant if a successor annuitant is named, in which case, the policy will continue until maturity or the death of the successor annuitant
- A contractual continuation of the policy upon maturity, in which case, the policy continues with a new maturity date.

Adjusted Cost Base

The adjusted cost base (ACB) of the segregated fund policy is important in determining whether the owner realizes a capital gain or a capital loss upon the disposition of the segregated fund policy or a portion thereof. It is important to note that the fund administrator will track and calculate each policy owner’s ACB.

The following factors most often affect the ACB:

Increase the ACB	Any deposits into the policy
	The sum of all amounts reported on the T-3 slip
Decrease the ACB	Any capital losses allocated to the client
	The portion of the ACB allocated to a partial disposition

The maturity and death benefit (top-up) payments on the maturity date or at the time of death of the annuitant respectively do not impact the calculation of the policy owner’s ACB. As such, pursuant to our current interpretation of the Income Tax Act, the payment of any maturity benefit guarantee or death benefit guarantee top-up payment will be considered a capital gain and such amount will be reported on the policy owner’s annual T-3 slip in the year of receipt.

Fund Switches

Switches between funds within the segregated fund policy can trigger a capital gain or a capital loss that will be reported to the policy owner by the fund administrator. A capital gain will be realized, if the market value of the fund that is being disposed is in excess of the policy owner’s ACB of that fund at the time of the switch. Conversely, a capital loss will be realized if the market value of the fund is less than the policy owner’s ACB of that fund at the time of the switch.

Summary of Fund Switches and Other Changes

Example	Contractual Term	Potential Impact on Policy Guarantees	Taxable Disposition
Moving from fund A to fund B with the same sales charge option in the same policy	Switch	No	Yes
Moving to the same or different fund with a different sales charge option in the same policy	Sell & Buy	Yes	Yes
Moving to the same fund from one (non-registered) policy to another	Transfer ¹	No	Yes
	Sell & Buy ²	Yes	Yes

¹ Contracts have same attributes (e.g. Contract Maturity Date , guarantees).

² Contracts have different attributes.

Common Ownership Structures

The following are some common examples of how corporate-owned segregated fund policies are structured:

Owner (policy owner)	Annuitant	Successor Annuitant	Beneficiary	Who died?	What happens on death	Tax Implications
ACME Corp.	Alex (the corporation's owner)	Betty (an executive in the corporation)	ACME Corp.	Alex	Policy continues in force with the surviving annuitant (Betty)	None, not a disposition
ACME Corp.	Alex (the corporation's owner)	N/A	ACME Corp.	Alex	Policy is terminated and the proceeds are paid to the beneficiary (ACME Corp.)	The gain is taxable to ACME Corp. and is not eligible for the Small Business Tax Rate, but would qualify for the Capital Dividend Account (CDA)

Administration

Please use the following checklist of requirements as a guideline when structuring a corporate-owned segregated fund policy:

- Check that the owner is a Canadian or Provincial Corporation
- Check that the application is accompanied by a **certified copy of a Corporate Resolution or Certificate of Incorporation** with Articles of Incorporation showing the full name of company and identifying the authorized signing officers of the corporation, their specimen signatures and stamped with the corporate seal (if available) or a **Certificate of Incumbency**, showing officer(s) or directors **and their specimen signatures**
- Check that the signing officer(s) has signed application form
- Check that the name of the corporation indicated on the application matches the government documentation
- Check that the business number is indicated in Section 3 of the Application (the BIN must have 11 digits)

Forms Required

The following forms must be completed and included with each segregated fund policy application:

- [BMO Guaranteed Investment Funds application \(592E\)](#) (Client Name Application)
- [Verification of Identity and Third-Party Verification \(576E\)](#) (Verification of Identity and Third-Party Determination)
- [Declaration of Tax Residence for Entities \(RC519E\)](#) (Declaration of Tax Residence for Entities)
- [BMO Guaranteed Investment Funds Client Name Based Series – Client Account Agreement \(957E\)](#) (Client Account Agreement for Class F Client Name Contracts)
- [Politically Exposed Persons Questionnaire \(420E\)](#) (To be completed for any deposit of \$100,000 or more)

Frequently Asked Questions

What forms and applications need to be completed to issue a segregated fund policy?

For easy access to the forms and applications needed to issue a segregated fund policy, please refer to the [Quick Start Guide for Advisors \(828E\)](#) which can be found on our Advisor site located at bmoinsurance.com/advisor/gif.

If a corporation doesn't have a calendar year-end, does it need to prorate the amount of taxable income reported on the T-3 it receives each year to match the corporate fiscal period?

Yes, the proportionate amount of income would be reported by the corporation, based on its applicable tax return.

How to get creditor protection and tax risks?

Creditor protection rules for an insurance policy (includes segregated fund contract) varies between Common and Civil law jurisdictions. Quebec is governed under Civil law and creditor protection is based on the relationship between the policy owner and the beneficiary falling within a prescribed family class or is irrevocable. Given the corporate ownership structure contemplated by this document, a family prescribed class relationship cannot exist in Quebec, so creditor protection is not available for corporate-owned segregated fund contracts in that province.

In common law provinces the key relationship is between the insured and the beneficiary. If those parties fall within the prescribed family class, creditor protection is available. Naming a family member as a beneficiary on a corporate owned and funded segregated fund contract may result in shareholder benefits for tax purposes. It is unclear whether those shareholder benefits arise at time of funding or only when a payment is made to the beneficiary.



NOTE: It is generally not recommended to name family members as beneficiaries on corporate owned segregated fund contracts, due to these tax consequences. Clients will have to weigh the importance of creditor protection versus the tax costs involved, when structuring the contract to be eligible for such protection. Please consult with your tax experts about the reasonableness of such structures for their individual circumstances.

What happens if the corporation is sold?

If the shares of the corporation are sold, all underlying assets of that corporation move with the share ownership transfer. The capital gain or loss realized by the selling shareholder will be based on the value of the corporation, which reflects the underlying value of all assets less liabilities. A segregated fund contract would be reflected in the share values.

If the shareholder wanted to retain the segregated fund contract, they would have to transfer it out of the corporation prior to sale. Such a transfer would be a disposition by the corporation possibly resulting in a capital gain or loss. For more details see "A] Transfer the segregated fund contract before the wind-up", in the FAQ below.

What happens if the corporation is amalgamated?

An amalgamation is the continuance of two corporations as opposed to a disposition. There are no tax consequences relating to a segregated fund contract that forms part of an amalgamation transaction. The policy ownership is changed but all values and tax attributes are retained.

What happens if the company is wound up?

The Income Tax Act (Canada) ITA has two set of rules that deal with wind-ups. The first is a wind-up of a subsidiary corporation into a parent corporation, both terms defined in subsection 88(1) ITA. Those wind-ups can be done on a tax neutral basis if all conditions specified in the ITA are met.

The second type of wind-up is where a private corporation is owned by an individual who no longer needs the corporation (we sometimes see this with professional corporations several years after the professional has retired). Subsection 88(2) ITA is then the relevant provision.

To determine the quantum of the tax outcome for a subsection 88(2) ITA transaction with respect to a segregated fund policy, if any, one would need to know the policy Adjusted Cost Basis (ACB), and Fair Market Value (FMV) along with other share related details. With that information in hand, two routes for the transfer of the policy are available, a transfer before wind-up or a wind-up.

A] Transfer the segregated fund contract before the wind-up

A disposition between related parties (i.e. the corporation and its shareholder) has both a potential capital gain/loss to the corporation and a shareholder benefit element to it. First, the corporation will be deemed to have transferred of the policy for Proceeds of Disposition (POD) equal to its FMV. If the POD are greater than the ACB, a capital gain will be reported to the corporation. If the FMV is less than the ACB, a capital loss will be reported.

Second is the determination of a shareholder benefit. If the FMV of the segregated fund policy is greater than the amount paid by the shareholder to acquire it, the difference will be a shareholder benefit which is fully taxable in the hands of the shareholder and is non-deductible to the corporation. The policy ACB is bumped up to FMV in the hands of the shareholder.

Alternatively, the segregated fund policy could be transferred as a dividend in-kind equal to its FMV. The company may be able to recover Refundable Dividend Tax on Hand (RDTOH) or utilize any balance in their Capital Dividend Account to reduce the tax

impact to the shareholder. A shareholder is now taxed as receiving a dividend for the FMV of the policy but gets no ACB bump. As with any distribution to corporate shareholders, one must take into consideration the potential implication of subsection 55(2) of the Income Tax Act (ITA). Finally, the corporate structure and the legal rights of the class of shares must be considered whenever a dividend is contemplated.

B] Wind-up

A wind-up that *does not* qualify under subsection 88(1) [wind-up of a subsidiary; not addressed in this memo] likely results in a deemed dividend pursuant to 84(2) ITA. The deemed dividend is equal to the FMV of the assets distributed less the paid-up capital of their shares. If the segregated fund policy is the only asset remaining, the POD will equal the FMV of the policy less paid-up capital. The shareholder is taxed on this amount as a dividend and the corporation is taxed on any capital gain that may arise when the segregated fund policy's FMV exceeds its ACB.

Can the contract be leveraged?

A segregated fund contract is a valuable asset that could be leveraged like any other investment asset. In fact, the guarantees may make it a very attractive form of collateral. Clients would need to check with their financial institution to see whether they would accept such a contract for leveraging purposes and what collateral value would be assigned.

Does a segregated fund contract qualify as a Publicly Traded Security?

Yes, as such it can be donated to a registered charity without triggering capital gains taxation on any deferred gains (a gain still arises but is excluded for tax purposes). The full amount of any gain from the donation results in a 100% credit to the corporation's Capital Dividend Account (CDA), as no portion of the gain is taxable.

NOTE: If contemplating such a transaction be sure to discuss it with the insurance carrier in advance, to ensure they can process such a transaction and the requirements for doing so are met.

Can a segregated fund contract be rolled into a corporation on a tax deferred basis?

A segregated fund is eligible property for purpose of a section 85 of the ITA. The Canada Revenue Agency (CRA) commented at a Conference for Advanced Life Underwriting (CALU) that a segregated fund contract may have both an interest in a segregated fund trust (eligible property) and a remainder interest representing insurance coverage (which would not be eligible property). The remainder interest may include things like the guarantees, but the value of such interests at the time of transfer will likely be minimal.

Based on CRA's response, if a client is transferring a policy to a corporation pursuant to section 85, they should report two dispositions; one for the interest in the segregated fund trust and another for the remainder interest, even though the later may only have a minimal value. The client may need to engage an actuary to determine the separate values.

Although it is not possible for corporate-owned segregated fund policies to be registered, can a corporation make contributions to an individual RRSP or TFSA?

Yes, a corporation can contribute to an individual's RRSP. However, it's advisable to understand the potential tax implications and benefits of such a transaction. Please consult with your tax experts about the reasonableness of such a structure for your client's individual circumstances.

Can a segregated fund generate credits to the Capital Dividend Account (CDA)?

Yes, the non-taxable portion of realized capital gains/losses reported on a T3, as well as the non-taxable portion of any death benefit or maturity guarantee received, are eligible for CDA treatment. Payment of policy values received upon death (other than the death benefit guarantee, if any) do not qualify for CDA treatment as they are not death benefits for tax purposes.

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