Corporate-owned life insurance considerations

Corporate-owned life insurance provides you, your business and your family with protection to meet your goals. Many business owners also use corporate-owned life insurance to meet their estate and financial objectives tax-efficiently. This article will look at the main considerations and tax concepts about corporate-owned life insurance.

The main benefits and drawbacks for corporate owned life insurance include:

Benefits	Drawbacks
Ability to direct funds to meet stated goals (e.g. key person coverage, liquidity for shareholder buy-out, estate planning)	Cash surrender value (CSV) is a passive asset for the corporation and may affect tax planning opportunities
Premiums often paid with cheaper after-tax corporate dollars	Transferring the policy at a later time is a taxable disposition and may result in taxes owing
Growth within the policy generally occurs tax deferred (up to exempt limits)	Provincial creditor protection for protected class beneficiaries is likely not available and subject to claims of creditors since beneficiary will be corporation to avoid a taxable benefit
Entire death benefit received tax-free. Net proceeds can flow out to shareholders tax free using the capital dividend account	Taxable benefits can arise without proper planning

Purpose of life insurance policy

Business purposes include replacing a key person, covering debt repayment, or buying out another shareholder. A shareholder may also want to meet personal tax or estate planning goals using corporate-owned life insurance. In many cases, it will be a combination of business and personal purposes. Ultimately, determine where you need the funds and work from there to decide the best owner for the policy.

Funding the premiums

Funding the premiums is more than deciding whether there is surplus cash flow within your corporate structure. Considerations relevant when looking at funding include the following:

Deductibility of premiums

Premiums for life insurance are generally not deductible, whether held personally or corporately. This means you pay premiums with after-tax dollars.[1]

Corporate versus personal after-tax dollars

Corporate tax rates for small businesses in Canada are generally lower than personal tax rates.[2] As a result, using after-tax corporate dollars to fund life insurance premiums can produce significant savings. As an example, assume a corporate tax rate of 12% and a personal tax rate of 50%. Life insurance premiums of $10,000 result in the following funding requirement:

Corporate funding		Personal funding
$11,364	**VS**	$20,000

You or your corporation need the above amount before-tax to have enough after-tax money to pay the premium. However, not all corporations benefit from the lower tax rate. Further, not all individuals have personal tax rates above the corporate tax rate. Review your specific situation with your professional advisors.

Corporate structure considerations

Corporate structures may include several different entities, including operating companies, holding companies and family trusts. Where there is more than one entity, choosing where to hold the policy requires more planning.

Placing a policy inside a holding company will aid in protecting it from the creditors of the operating company. It may also allow for added tax planning opportunities.[3]

Moving funds between corporations requires tax and accounting advice. Tax-free intercorporate dividends are one tax-efficient method of moving funds. However, take care to ensure that funds can in fact move between the corporations without incurring taxes. Due to changes to the Income Tax Act (ITA) over the years, moving funds between corporate groups has become more complex. Not all dividends between corporations are tax-free and therefore require professional tax advice. Review your corporate structure with your professional advisors.

Corporate succession and estate planning considerations

A corporate-owned life insurance policy is an asset of the corporation. Therefore, you need to be aware of the following considerations:

Capital dividend account

A corporate beneficiary receives the death benefit tax-free. Net proceeds (generally the death benefit less adjusted cost basis (ACB) of the policy) create a credit to the capital dividend account (CDA). A corporation can then pay capital dividends tax-free to the shareholders of the corporation.[4]

Taxable benefits

In most situations, the owner, payor and beneficiary of corporate-owned life insurance is the same corporation. It may be tempting to name a specific person as beneficiary to ensure the funds flow to that person. However, if an individual or other corporation is beneficiary, a taxable benefit may arise under the ITA.[5]

There are valid planning strategies where the owner, payor and beneficiary are not the same corporation.[6] Further, you may be able to direct funds using life insurance shares as a planning tool. Implementing these strategies requires advanced planning with your professional advisors.

CSV is a passive asset for the corporation

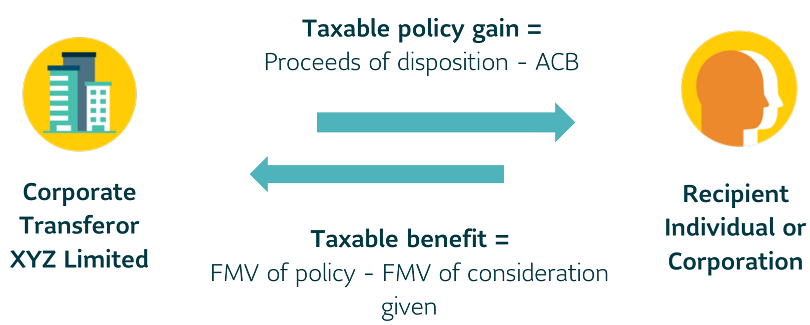
Many life insurance policies have a cash value or savings component that allows tax-deferred growth within a policy. In general, the CSV of a life insurance policy is a passive asset inside the corporation. This can result in restricting an individual shareholder's lifetime capital gains exemption (LCGE) on sale of the corporation's shares. As such, the corporation might need to move the policy resulting in taxable disposition (see below).

Creditor protection

Provincial legislation across Canada exempts certain policies from seizure by a policy owner's creditors during their lifetime. This creditor protection is available where the beneficiary is an irrevocable beneficiary. It is also available where the named beneficiary is from the "protected class" prescribed by provincial law. The protected class generally includes spouses, children, grandchildren, and parents.[7] It is important to note the provincial creditor protection is not absolute. If a corporation owns the policy, the beneficiary is generally the same corporation. Therefore, it will not benefit from the provincial creditor protection provisions.

What happens if my goal or corporate structure change?

Circumstances and your goals can change over time. You may need to transfer the policy out of the corporation. A transfer is a deemed disposition under the ITA if the transferor and transferee (recipient) are non-arm's length.[8] This is true whether you transfer the policy to an individual or other corporation. There are no tax deferred rollover rules available in the ITA when transferring a life insurance policy from a corporation.[9] The tax effect for both the transferor and the recipient is important. You will need the CSV, ACB, and fair market value (FMV) of the policy.[10] In addition, you will need the FMV of the amount of consideration given by the recipient for the policy.



Corporate Transferor – there is a taxable policy gain equal to the "proceeds of disposition" less the ACB of the policy. The "proceeds of disposition" is the greater of the CSV, ACB and the FMV of consideration given.[11] Taxable policy gains are fully included in the corporation's income in the year of transfer. It will be taxable at the corporation's investment tax rate.

Recipient – the tax effect depends on how much the non-arm's length recipient gives to the transferor corporation for the policy. If the recipient pays less than the FMV of the policy, there is generally a taxable benefit. The taxable benefit is the difference between the FMV of the policy and the consideration given for the policy.[12] The recipient's new ACB for the policy is the "proceeds of disposition" plus any taxable benefit assessed on the transfer.

Before transferring a corporate-owned policy, review your situation with your professional advisors.

Summary

Holding a life insurance policy within your corporation may provide significant tax savings. It can also allow you to meet your business, financial, tax and estate planning goals. Make sure to review your situation with your advisor today.

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[1] Premiums may be deductible where a policy is collaterally assigned to a financial institution to secure borrowed funds used for the purposes of producing income if all the statutory conditions are met.
[2] Canadian controlled private corporation tax rates range from 9% to 12.20% across Canada for active business income below the small business deduction threshold and 23% to 31% for active business income above the small business deduction threshold. Top personal tax rates range from 44.50% to 54.80% across Canada.
[3] A holding company may assist in ensuring the operating company's passive assets do not surpass a certain threshold and therefore allow the shareholder to benefit from the lifetime capital gains exemption. In addition, if the operating company will be sold in later years, placing the policy in a holding company reduces the need for future transfer of the policy.
[4] Dividends may be subject to restrictions in the company's constituting documents or any shareholders' agreement in place. In addition, the ability to pay the entire death benefit out of the CDA may be restricted by other components of the CDA calculation.
[5] Taxable benefits can arise under various provisions of the ITA. A taxable benefit creates potential for double taxation since premiums are paid with after-tax corporate dollars and the amount of a taxable benefit is fully included in the recipient's income and taxed again at the recipient's marginal tax rates (without benefit of dividend tax credits for integration).
[6] These include shared ownership and shared benefit strategies as well as situations where one corporation owns the life insurance policy and names one or more other corporations as beneficiary to ensure proper flow of funds for business planning purposes.
[7] All provinces (except Quebec) and territories include the spouse, child, grandchild, and parent of the life insured as a "protected class". NWT, BC, AB, SK, MAN, ON and NS extend this to common law partners. In Quebec, the relationship must be between the owner and the beneficiary of the policy and extends to the spouse, civil union spouse and all ascendants and descendants of the owner.
[8] Although arm's length transfers can occur, most transfers of a corporate held policy will be between non-arm's length persons. Arm's length transfers are also deemed dispositions under the ITA but are subject to different rules. The discussion in this article assumes non-arm's length persons throughout.
[9] Tax deferred rollovers are available between spouses or between grandparents/parents and their children/grandchildren if certain conditions are met.
[10] The CSV and ACB of the policy can be obtained from the life insurance company and vary by type of life insurance policy. An independent third-party actuarial valuation determines the FMV of a policy. A policy with no CSV can still have a FMV.
[11] The FMV of the consideration given may differ from the FMV of the life insurance policy itself. In essence, the FMV of the consideration given is the amount the recipient gives to the transferor in exchange for the policy.
[12] The potential for a taxable benefit is reduced if the policy is transferred as a "dividend in kind". In such cases, it is best to seek professional advice prior to transfer.